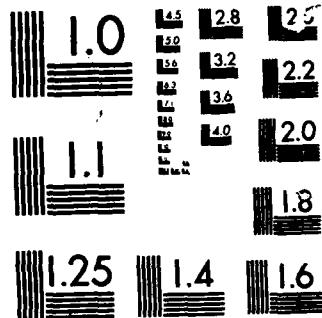


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# ABSTRACT

## FINANCIAL STATEMENTS: DISCLOSURES AND PRESENTATIONS

by Lori A. Skipper, B.B.A.

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DEGREE AWARDED: M.B.A. INSTITUTION: The UNIVERSITY of TEXAS at Austin

Many of the less common accounting events or transactions are either described briefly or not covered at all in the typical first year accounting textbook. The purpose of this professional report is to extend the scope of the coverage of presentation and disclosure issues associated with financial statements provided in these textbooks. The methods of disclosure discussed include parenthetical explanations, footnotes, supporting schedules, cross references, and valuation accounts. These presentations are illustrated by actual financial statements.

The disclosures covered include examples of General Disclosures, Extended Scope Disclosures, and Specialized Industry Disclosures, as well as typical footnote disclosures. General Disclosures apply to all publicly held enterprises. Extended Scope Disclosures apply to all publicly held enterprises, that fulfill certain size or scope of operations criteria. Specialized Industry Disclosures are required of enterprises that operate within the specified industry. The notes to the financial statements are fairly typical with respect to all enterprises.

*will qualify as an unqualified opinion*  
Audit reports are presented to illustrate the necessity for proper presentation and disclosure in financial statements. An unqualified opinion may be rendered when the financial statements are prepared in full compliance with GAAP, consistently applied. Inadequate disclosures as well as other conditions may result in a qualified opinion. This may be an "except for" qualified opinion or even a disclaimer of opinion. Unusual uncertainties can result in a "subject to" qualified opinion or even an adverse opinion.

*and this*  
This professional report is expected to be useful as a supplement to the typical textual materials available for teaching financial accounting principles. —

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FINANCIAL STATEMENTS: DISCLOSURES AND PRESENTATIONS

APPROVED:

Robert D. Larson

**FINANCIAL STATEMENTS: DISCLOSURES AND PRESENTATIONS**

**by**

**LORI ANN SKIPPER, B.B.A.**

**PROFESSIONAL REPORT**

**Prepared for B.A. 398 Under the Supervision of  
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**for the Degree of**

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## CHAPTER I

### INTRODUCTION

The purpose of this professional report is to extend the scope of the coverage of presentation and disclosure issues associated with financial statements provided in the typical first year account textbook. The term disclosure is used as defined in Kohler's dictionary for Accountants:

an explanation, or exhibit, attached to a financial statement, or embodied in a report (e.g., an auditor's) containing a fact, opinion, or detail required or helpful in the interpretation of the statement or report; an expanded heading or a footnote.<sup>1</sup>

Textbooks written for the beginning accounting student generally concentrate on the more frequently occurring accounting events or activities. Many of the less common events or activities are either described briefly or not mentioned at all. In Chapters II through IV of this report thorough coverage of the disclosure and presentation issues associated with some of these less common events or activities is provided. Examples from actual financial statements are used to illustrate the required disclosures and the manner of presentation for each event. Emphasis is placed on the full disclosure principle. Chapter II covers General Disclosures. These include disclosure requirements that generally apply to all enterprises,

regardless of size, scope of operations, or industry classification.<sup>2</sup> These disclosures are all made in the primary financial statements. The primary financial statements are the balance sheet, the income statement, and the statement of changes in financial position. Chapter III reviews Extended Scope Disclosures. These disclosure requirements apply only to enterprises that meet specific criteria relating to attributes such as size or ownership.<sup>3</sup> Chapter IV covers selected Specialized Industry Disclosures. "These requirements apply to only the specific industry identified."<sup>4</sup> In these three chapters, each accounting event is discussed in terms of the disclosure and presentation requirements for each of the financial statements affected, as well as the notes that accompany them.

There are five generally accepted forms of supplemental disclosure that are illustrated in the chapters that follow. They are:

1. parenthetical explanations.
2. footnotes.
3. supporting schedules.
4. cross references.
5. valuation accounts.<sup>5</sup>

Parenthetical explanations are annotations enclosed in parenthesis after a balance sheet account. Since they are included in the body of the financial statement the information is readily available without having to turn

to another page. An example of a parenthetical explanation can be found in the 1984 annual report of TRW, Inc. The balance sheet contains the following information under current assets:

Cash and marketable securities	
(at cost which approximates market)	\$80,662 <sup>6</sup>

Footnotes on the other hand require the reader to look up the desired information in the notes to the financial statements. If the amount of information required is too lengthy for a parenthetical explanation, a footnote should be used. A typical disclosure of this type can be found in the 1984 annual report of the American Broadcasting Companies, Inc. The Statement of Consolidated Earnings includes the following:

Per Share Earnings (note H)	\$6.71	\$5.45	\$5.54
-----------------------------	--------	--------	--------

Then in the notes to the financial statements the corresponding note appears as follows:

Note H: Per Share Earnings

Earnings per share has been computed based upon the weighted average number of shares outstanding during each year. The approximate number of shares used in the computations were 29,096,000 in 1984, 29,325,000 in 1983 and 28,900,000 in 1982.<sup>7</sup>

Certain accounts appear on the balance sheet as one line entries but a supporting schedule is required to provide detail on the way the figure was derived. For instance the 1982 annual report of the Campbell Soup Company lists inventories of \$470,385. The notes to the financial statements include this supporting schedule:

Inventories

Raw materials, containers and supplies	\$277,951
Finished products	<u>279,665</u>
	557,616

Less-Adjustment of inventories to  
LIFO basis

	<u>87,231</u>
	\$470,385 <sup>8</sup>

When two accounts on the balance sheet have a direct relationship that needs to be highlighted a cross reference is used. For example:

Current Assets

Cash restricted to redemption of current maturing bonds-see current liabilities	\$1,200,000
---	-------------

Current Liabilities

Bonds maturing in the current period-see current assets	\$1,200,000 <sup>9</sup>
--	--------------------------

Finally, valuation accounts are used to adjust the carrying amount of certain liability and asset accounts presented in the financial statements. For instance a bond premium (discount) increases (decreases) the face value of a bond payable. A valuation account would be similar to the following:

Equipment	\$18,000,000	
Less accumulated depreciation	<u>(1,625,000)</u>	\$16,375,000 <sup>10</sup>

Some of the more common notes to the financial statements are examined in Chapter V. Several notes from actual financial statements are used to illustrate the method of disclosure and presentation.

The content and significance of audit opinions are reviewed in Chapter VI. Actual audit opinions are provided to exemplify the differences between the types of opinions that are rendered.

This report is not all inclusive. Though this report includes many of the less common accounting events or activities, it is not inclusive of all of those events not covered in any one accounting textbook. Also the reader is assumed to have a basic understanding of accounting concepts and principles. Therefore lengthy explanations of these events are not included. This professional report is expected to be useful as a supplement to the typical textual materials available for introducing students to financial accounting principles.

## CHAPTER II

### GENERAL DISCLOSURES

This chapter contains a discussion of several different general disclosure requirements. Included are: adjustments of financial statements for prior periods, consolidations, contingencies, discontinued operations, extraordinary items, and unusual or infrequent items.

#### Adjustments Of Financial Statements For Prior Periods

The requirements for the adjustment of financial statements of prior periods are promulgated in APB Opinions 9 and 20 and FASB Statements 16 and 73. Prior year financial statements are said to be restated, but no prior year annual reports are reissued. Rather, information from the prior year financial statements is included in the current year annual report in order to enhance comparison.

Adjustment of previously issued financial statements for inclusion in the current year annual report is required in three general cases. The first of the three general cases involves prior period adjustments. Prior period adjustments usually pertain to the correction of an error in a previous year's financial statements.<sup>11</sup>

The second case is adjustments to prior interim period financial statements for changes related to prior interim periods of the current fiscal year. The third case is in the

event of a change in accounting principle. Not all changes in accounting principles require restatement of prior period financial statements. The instances that do include changes in reporting entity and a few special cases of a change from one generally accepted accounting principle to another. In all of these cases, except changes in prior interim periods of the current year, the change is not included in the determination of income for the current year. Instead, adjustments are made directly to the beginning balance of retained earnings for the current year. For each year that adjustments are made the effect on income before extraordinary items, net income, and the related per share amounts must be disclosed. Disclosure is only required in the financial statements of the period in which the restatement is made and not in any subsequent financial statements.

#### Prior Period Adjustments

Errors can occur from mathematical mistakes, improper application of accounting principles or an oversight or misuse of facts present when the financial statements were prepared.<sup>12</sup> Since a change in an accounting estimate results from new information not available at the time that the financial statement were prepared, it is not considered to be a correction of an error. Changes in accounting principles are not generally considered to be corrections of errors. However, the correction of errors does include changing from

an accounting principle that is not generally accepted to one that is generally accepted.<sup>13</sup>

The nature of the error must be disclosed in the financial statements of the period in which it was found and corrected.<sup>14</sup> Disclosure is accomplished through a note to the financial statements. For example, the 1982 Annual Report for PEPSICO included a restatement of prior year financial statements to correct an error. The disclosure of this restatement was made in the notes to financial statements shown in exhibit 2-1. In addition to the nature of the error the note includes the disclosure of the effect of the correction on income before extraordinary items, net income and the related per share amounts. These disclosures are shown via a table within the note.

In the case of single period financial statements, the corrected income statement is accomplished by an adjustment to the beginning balance of retained earnings.<sup>15</sup> By contrast, in comparative financial statements such as PEPSICO's, all pertinent balances in the affected prior years must be adjusted to reflect the correction of the error.<sup>16</sup> This is illustrated by comparing the 1980 and 1981 balances in the respective income statements for PEPSICO in the 1981 annual report in exhibit 2-2 with the same years in the 1982 annual report in exhibit 2-3. Net sales, cost of goods sold, marketing and administrative expenses, interest

Exh. 2-1. Disclosure of a restatement of prior year financial statements and unusual item in the notes to the financial statements. (Pepsico, Inc., Annual Report 1982, p. 46.)

**Note 2/Restatement and Unusual Charge**

In December 1982 PepsiCo completed a review of financial irregularities in company-owned foreign bottling operations, primarily in Mexico and the Philippines. As a result of this review steps have been taken to correct these irregularities, prevent their recurrence and terminate the individuals responsible.

The investigation, conducted by a task force that included special legal counsel and independent accountants, revealed that managers of these subsidiaries working in collusion falsified documents and evaded internal controls to overstate profits and thereby improve the apparent performance of their operations.

These irregularities caused an overstatement of assets, an understatement of liabilities and an overstatement of net income for the period of January 1, 1978 through September 4, 1982, aggregating \$92.1 million or 6.6 percent of net income. These adjustments were without tax benefit. As a result of the irregularities, the financial statements for the years 1978 through 1981 have been restated. A reconciliation of previously reported net income and net income per share to restated amounts is shown in the table below. The impact of the restatement on revenues was not significant. Interim financial data for previously reported quarters has also been restated (see quarterly disclosure on page 38).

**Change in Net Income and Net Income per Share:**

	1981	1980	1979	1978
	(in thousands except for per share amounts)			
Income before extraordinary charge as previously reported	\$333,456	\$291,752	\$264,855	\$225,769
Decrease in income resulting from restatement	35,972	31,047	14,466	2,555
Income before extraordinary charge as restated	297,484	260,705	250,389	223,214
Extraordinary charge (see Note 11)	—	17,762	—	—
Net income	<u>\$297,484</u>	<u>\$242,943</u>	<u>\$250,389</u>	<u>\$223,214</u>
Income per share before extraordinary charge as previously reported	\$3.61	\$3.20	\$2.85	\$2.43
Decrease in income per share resulting from restatement	.39	.34	.15	.03
Restated income per share before extraordinary charge	3.22	2.86	2.70	2.40
Extraordinary charge	—	.19	—	—
Net income per share	<u>\$3.22</u>	<u>\$2.67</u>	<u>\$2.70</u>	<u>\$2.40</u>

As a result of the restatement previously reported retained earnings at the beginning of 1980 has been reduced by \$17,021,000 from \$1,134,060,000 to \$1,117,039,000.

In addition to investigating financial irregularities, the company also conducted a review of financial practices at company-owned foreign bottling operations. As a result of this review, the net assets of

certain operations have been reduced by an amount totaling \$79.4 million. This reduction primarily involves a reassessment of the bottle and case inventories required for current operations, and has been accounted for as an unusual charge to earnings, without tax benefit, during the fourth quarter of 1982. The charge reduced net income per share by \$.83.

Exh. 2-2. Income statement in prior year annual report for comparison with restatement in current year annual report - see Exh. 2-3. (Pepsico, Inc., Annual Report 1981, p. 45.)

### **Consolidated Statement of Income and Retained Earnings**

(in thousands except per share amounts)

PepsiCo, Inc. and Subsidiaries

Years ended December 26, 1981; December 27, 1980 and December 29, 1979

	1981	1980	1979
<b>Revenues</b>			
Net sales	\$6,249,979	\$5,271,598	\$4,488,032
Other operating revenues	777,464	703,622	602,535
	<u>7,027,443</u>	<u>5,975,220</u>	<u>5,090,567</u>
<b>Costs and Expenses</b>			
Cost of sales	2,838,482	2,461,087	2,113,592
Cost of other operating revenues	603,548	545,419	474,129
Marketing, administrative and other expenses	2,942,066	2,393,683	2,022,115
Interest expense	143,884	114,149	73,121
Interest income	(44,830)	(31,951)	(25,520)
	<u>6,482,960</u>	<u>5,482,387</u>	<u>4,657,437</u>
	544,483	492,833	433,130
Provision for United States and foreign income taxes (including deferred: 1981—\$22,400; 1980—\$22,800; 1979—\$25,800)	211,027	201,081	169,275
<b>Income Before Extraordinary Charge</b>	333,456	291,752	264,855
<b>Extraordinary Charge</b>			
Write-off of motor carrier operating rights	—	17,762	—
<b>Net Income</b>	333,456	273,990	264,855
Retained earnings at beginning of year	1,293,164	1,134,060	971,654
Cash dividends (per share: 1981—\$1.42; 1980—\$1.26; 1979—\$1.105)	(129,944)	(114,886)	(102,449)
Retained earnings at end of year	<u>\$1,496,676</u>	<u>\$1,293,164</u>	<u>\$1,134,060</u>
<b>Net Income Per Share</b>			
Income before extraordinary charge	\$ 3.61	\$ 3.20	\$ 2.85
Extraordinary charge	—	19	—
Net income	<u>\$ 3.61</u>	<u>\$ 3.01</u>	<u>\$ 2.85</u>

Exh. 2-3. Presentation of a restatement of prior year income statements and an unusual item. (Pepsico, Inc., Annual Report 1982, p. 39.)

### **Consolidated Statement of Income and Retained Earnings**

(in thousands except per share amounts)

PepsiCo, Inc. and Subsidiaries

Years ended December 25, 1982, December 26, 1981 and December 27, 1980

	1982	1981*	1980*
<b>Revenues</b>			
Net sales	\$6,747,989	\$6,249,843	\$5,271,659
Other operating revenues	751,009	777,464	703,622
	<u>7,498,998</u>	<u>7,027,307</u>	<u>5,975,281</u>
<b>Costs and Expenses</b>			
Cost of sales	2,938,827	2,849,004	2,475,597
Cost of other operating revenues	583,226	603,548	545,419
Marketing, administrative and other expenses	3,333,359	2,961,657	2,410,005
Interest expense	166,194	149,667	114,673
Interest income	(53,089)	(44,830)	(31,951)
	<u>6,968,517</u>	<u>6,519,046</u>	<u>5,513,743</u>
<b>Income Before Income Taxes, Unusual and Extraordinary Charges</b>	530,481	508,261	461,538
Provision for United States and foreign income taxes (including deferred: 1982—\$74,200; 1981—\$22,300; 1980—\$22,800)	<u>226,793</u>	<u>210,777</u>	<u>200,833</u>
<b>Income Before Unusual and Extraordinary Charges</b>	303,688	297,484	260,705
<b>Unusual Charge</b>			
Reduction in net assets of foreign bottling operations (without tax benefit)	<u>79,400</u>	<u>—</u>	<u>—</u>
<b>Income Before Extraordinary Charge</b>	224,288	297,484	260,705
<b>Extraordinary Charge</b>			
Write-off of motor carrier operating rights	<u>—</u>	<u>—</u>	<u>17,762</u>
<b>Net Income</b>	224,288	297,484	242,943
Retained earnings at beginning of year	1,412,636	1,245,096	1,117,039
Cash dividends (per share: 1982—\$1.58; 1981—\$1.42; 1980—\$1.26)	<u>(147,127)</u>	<u>(129,944)</u>	<u>(114,886)</u>
<b>Retained earnings at end of year</b>	<u>\$1,489,797</u>	<u>\$1,412,636</u>	<u>\$1,245,096</u>
<b>Net Income Per Share</b>			
Income before extraordinary charge	\$ 2.40	\$ 3.22	\$ 2.86
Extraordinary charge	<u>—</u>	<u>—</u>	<u>.19</u>
<b>Net income</b>	<u>\$ 2.40</u>	<u>\$ 3.22</u>	<u>\$ 2.67</u>

\*As restated

See accompanying notes

expense, provision for income taxes, income before extraordinary items, net income and related per share amounts in the 1982 annual report have been corrected. There is no need to adjust the beginning balance of retained earnings in 1982 since it is already correct due to the restatement of the prior years.

Whether single period or comparative financial statements are used the net effect is the same; the correction of the error results in an adjusted beginning balance of retained earnings for the current year. Therefore, net income is determined only by the events of the current year and not affected by the discovery and correction of an error in prior periods. Note that the 1980 and 1981 columns in the 1982 PEPSICO statements are annotated by an asterisk which corresponds to a footnote at the bottom of the financial statements. This is to further highlight the fact that those years have been restated. In the case of PEPSICO a comparative balance sheet and a consolidated statement of changes in financial position are also provided. This means that applicable prior period account balances in these statements must also be corrected. No adjustment is necessary to current year account balances. If historical summaries are presented any prior period in which an adjustment is required should have the applicable accounts adjusted with disclosure in the

first published financial statements in which the adjustments are made.<sup>17</sup>

Adjustments for Prior Interim  
Periods of the Current Year

Adjustment of prior interim period financial statements of the current year are required due to an "adjustment or settlement of litigation or similar claims, of income taxes, of renegotiated proceedings, or of utility revenue under rate-making processes."<sup>18</sup> Before adjustments are permitted three criteria must be met.

1. The effect of the adjustment must be material.
2. It must be related, all or in part, to a prior interim period of the current year.
3. It could not have been accounted for in a reasonable manner at the time the statement was first prepared.<sup>19</sup>

Prior interim periods of the current year are restated as necessary to reflect changes in items of profit or loss related to that period.<sup>20</sup> If the required adjustment is related to events in prior years it is used to determine the net income of the first interim period of the current year.<sup>21</sup> Disclosure will include the effect on income from continuing operations, net income, and the related per share amounts.<sup>22</sup>

Accounting Changes that Require  
Adjustment of Prior Periods

Certain accounting changes such as a change in reporting entity require a footnote disclosure of the nature of and reason for the change. The effect on income before extraordinary items, net income, and related per share amounts must also be provided. This is done for all periods presented in the financial statements.<sup>23</sup> Other special changes in accounting principles include:

1. Change to or from the "full cost" method (extractive industries).
2. Change from LIFO to any other inventory pricing method.
3. Change in the method used to account for long-term construction contracts.
4. Retirement-replacement-betterment accounting to depreciation accounting.<sup>24</sup>

The disclosures required are the nature and justification for the change. The justification is necessary to explain why one generally accepted accounting principle is preferable to another generally accepted accounting principle. Also the effect of the change on income before extraordinary items, net income, and related per share amounts must be disclosed either on the face of the financial statements or in the notes.<sup>25</sup>

For accounting changes in which restatement is not allowed the enterprise may find it to be more beneficial to submit pro forma net earnings as if the income

statement had been restated. A pro forma statement is defined by Kohler as:

1. A financial statement containing at least in part hypothetical amounts, or no amounts, prepared to exhibit the form in which data of a particular kind are to be presented.
2. A financial statement modified to show the effect of proposed transactions which have not yet been consummated; an "as-if" statement.<sup>26</sup>

Exhibit 2-4 contains an excerpt from the consolidated statement of earnings of the Campbell Soup Company which illustrates this type of disclosure. For a review of the requirements for restating prior period financial statements see exhibit 2-5.

#### CONSOLIDATION

The requirements for the disclosure and presentation of consolidated financial statements are covered in Accounting Research Bulletin 43, chapter 12 and Bulletin 51, as well as in FASB Statement 13. Consolidation of financial statements is required whenever one company has a controlling interest in one or more other companies, except under a few circumstances.<sup>27</sup>

Consolidated statements are generally considered more meaningful than separate statements when one of the companies either directly or indirectly has a controlling interest in the other companies. This is to ensure fair presentation.<sup>28</sup> Whether accomplished by the purchase or pooling of interest method certain disclosures are required. First, the

Exh. 2-4. Presentation of pro forma net earnings on the income statement, provided due to an accounting change. (Campbell Soup Company, 1982 Annual Report, p. 23.)

**Consolidated Statements of Earnings**

(000 omitted)

	1982 (52 weeks)	1981 (52 weeks)	1980 (53 weeks)
Net sales	\$2,944,779	\$2,797,663	\$2,560,569
Costs and expenses			
Cost of products sold	2,221,341	2,172,806	1,976,754
Marketing and sales expenses	305,700	256,726	213,703
Administrative and research expenses	118,936	93,462	102,445
Interest - net	21,939	30,302	10,135
	<u>2,667,916</u>	<u>2,553,296</u>	<u>2,303,037</u>
Earnings before taxes	276,863	244,367	257,532
Taxes on earnings	<u>127,250</u>	<u>114,650</u>	<u>122,950</u>
Earnings before prior year effect of change in accounting principle	149,613	129,717	134,582
Prior year effect of 1980 change to LIFO method of inventory accounting			(12,927)
Net earnings	<u>\$ 149,613</u>	<u>\$ 129,717</u>	<u>\$ 121,655</u>
Per share (based on average shares outstanding):			
Earnings before prior year effect of change in accounting principle	\$ 4.64	\$ 4.00	\$ 4.08
Prior year effect of 1980 change to LIFO method of inventory accounting			(.39)
Net earnings	<u>\$ 4.64</u>	<u>\$ 4.00</u>	<u>\$ 3.69</u>
Pro Forma Net Earnings			
Although in accordance with generally accepted accounting principles the prior year could not be restated for the 1980 change to LIFO, these amounts report earnings as though the restatement had been made			
Net earnings	<u>\$ 149,613</u>	<u>\$ 129,717</u>	<u>\$ 134,582</u>
Net earnings per share	<u>\$ 4.64</u>	<u>\$ 4.00</u>	<u>\$ 4.08</u>

The accompanying Summary of Significant Accounting Policies and Notes are an integral part of the financial statements.

Exn. 2-5. Summary of accounting for accounting changes and error correction.  
(Patrick R. Delaney et al., GAAP Interpretation and Application, p. 489.)

ACCOUNTING CHANGES In Principle	Reporting on financial statements				Recording in books	
	Footnote disclosures		Statement disclosures		Direct dr./cr. to retained earnings account	Cumulative effect retained earnings account
	Nature of item	Justification*	Effect on income before X-items, NI, EPS Current yr. only	Retroactive treatment: previous financial statements restated		
General change in principle or method of application from one acceptable GAAP to another. (Change from unacceptable GAAP is correction of error.)	X	X	X			X
Special	X	X	X	X	X	
• LIFO to another method						
• Change in method of accounting for long-term construction contracts.						
• Change to or from "full cost" method of accounting in the extractive industries.						
Special Exemptions for closely held corporation when it changes principles before its initial public offering.	X	X		X	X	
FASB Mandated	X		X	X	X	
Examples: equity method, R&D costs, inflation accounting.						
In Estimate**			X***			
Natural occurrence because judgment is used in preparation of statements. New events, more experience, and additional information affect earlier good faith estimates.						
In Reporting Entity***	X	X	X	X		
Includes consolidated or combined statements in place of individual statements, change in group of subsidiaries for which consolidated statements are prepared, change in companies included in combined statements, and business combination accounted for as a pooling of interests.						
ERROR CORRECTION	X		X	X	X	
Mathematical mistakes, mistakes in applying principles, oversight or misuse of available facts, change from unacceptable to acceptable GAAP.						

\*Should clearly explain why the newly adopted accounting principle is preferable.

\*\*Change in estimate effected by a change in principle is accounted for as a change in estimate.

\*\*\*For material changes affecting more than just the current year.

consolidation policy must be disclosed either by the headings of the financial statements, or by other information in the financial statements.<sup>29</sup> The principles of consolidation state whether all subsidiaries, or just certain subsidiaries were included in the consolidation. It also states the method of accounting for any unconsolidated subsidiaries. An example of this kind of disclosure from General Motors' 1983 annual report is presented in exhibit 2-6. Foreign subsidiaries may or may not be included in the consolidation. Regardless of whether they are included or not adequate disclosure of foreign operations must be made.

Any intervening events that materially affect the financial position or results of operation must also be disclosed.<sup>30</sup> Such an intervening event is a difference in the fiscal periods used by the parent and a subsidiary. The principles of consolidation for Gulf + Western also shown in exhibit 2-6 include the disclosure of a possible intervening event. They provide a more detailed explanation of the method of accounting for unconsolidated subsidiaries.

A subsidiary whose principle business activity is leasing property to its parent or other affiliated companies must be included in the consolidation.<sup>31</sup> If the parent follows specialized industry practices for marketable securities and one or more of its subsidiaries do

Exh. 2-6. Disclosure of principles of consolidation in the notes to the financial statements. (General Motors, Annual Report 1983, p. 20 and Gulf+Western Industries, Inc., 1983 Annual Report, p. 44.)

***Principles of Consolidation***

The consolidated financial statements include the accounts of the Corporation and all domestic and foreign subsidiaries which are more than 50% owned and engaged principally in manufacturing or wholesale marketing of General Motors products. General Motors' share of earnings or losses of nonconsolidated subsidiaries and of associates in which at least 20% of the voting securities is owned is generally included in consolidated income under the equity method of accounting.

***Principles of Consolidation***

The consolidated financial statements include the accounts of Gulf+Western Industries, Inc. and its significant majority-owned affiliates other than its finance subsidiary (Company). The accounts of certain foreign subsidiaries are consolidated as of and for periods different from those of the Company, which practice has no material effect on the consolidated financial statements. The Company's investments in its unconsolidated finance subsidiary and 20-50% owned investees are carried on the equity basis. The equity in earnings before income taxes and foreign exchange gains or losses of the 20-50% owned investees is included under the heading "Other Income." The income taxes and foreign exchange adjustments of the unconsolidated finance subsidiary and investees are included in the provision for income taxes and selling, general and administrative expenses, respectively. Investments in other corporate securities are carried at amounts not in excess of cost.

not, the required disclosures for each practice must be made.<sup>32</sup>

Exhibit 2-2 and 2-3 are both examples of consolidated income statements. The amount of minority interest appears on the income statement as income from continuing operations net of taxes and in the statement of changes in financial position as a source of working capital from continuing operations. These presentations are shown in exhibit 2-7. If a subsidiary is sold during the year its revenue and expenses are not included in the income statement. Though identified separately, the parent's equity in the earnings of the subsidiary prior to its sale are included.<sup>33</sup> If the subsidiary was a business segment then disclosure follows the requirements for discontinued operations which are covered later in this chapter.

#### Contingencies

A contingency exists whenever there is a possibility of a gain or loss in the future depending upon the occurrence of some event.<sup>34</sup> The disclosure of contingencies is promulgated in FASB Statements 5, 16, and 38 and FASB Interpretations 14 and 34. Contingencies are handled differently depending on whether they involve a gain or loss.

Exh. 2-7. Disclosure and presentation of minority interest in the income statement, the statement of changes in financial position, and the notes to the financial statements. (Bell & Howell, 1984 Annual Report, pp. 9-15)

Earnings from continuing operations before taxes	46,667	41,636	31,268
Taxes on income:			
Provision for the year	16,654	17,002	12,721
Reversal of DISC deferred taxes	(4,465)	—	—
	12,189	17,002	12,721
	34,478	24,634	18,547
Minority interest	1,431	—	—
Earnings from continuing operations	33,047	24,634	18,547
Earnings (loss) from discontinued operations	—	9,342	(21,477)
Extraordinary credit	—	7,215	—
Net earnings (loss)	\$ 33,047	\$ 41,191	\$ (2,930)

(Dollars in thousands)	1984	1983	1982
<b>Sources of working capital:</b>			
Continuing operations			
Earnings from operations	\$ 33,047	\$ 24,634	\$ 18,547
Provision for depreciation	13,198	11,269	10,161
Provision (credit) for deferred income taxes	(2,310)	773	278
Minority interest	1,431	—	—
	45,366	36,676	28,986
Proceeds from long-term debt	49,500	—	14,200
Net proceeds from the sale of DeVRY INC. stock	—	17,521	—
Increase in deferred compensation	174	3,425	1,378
Disposals and adjustments of property, plant and equipment	2,018	4,360	1,770
Other—net	6,059	3,816	(4,496)
<b>Total sources</b>	<b>103,117</b>	<b>65,798</b>	<b>41,838</b>

**Principles of Consolidation.** The consolidated financial statements include all subsidiaries except the joint venture and financing subsidiary, described in Note C, which are accounted for on the equity basis. Minority interest represents the minority shareholders' proportionate share of the equity of DeVRY INC., a subsidiary which sold approximately 15% of its common stock in a public offering in December 1983. The company's equity in the net assets of DeVRY after the sale of its common stock exceeded the carrying amount of its investment. The gain of \$6,917 which is net of income taxes of \$3,468 was credited to capital surplus.

### Gain Contingencies

Gain contingencies are not included in the body of the financial statements. Including them might be misleading since revenue is not to be recognized until it is realized. Instead, the nature of the gain contingency is disclosed in the notes to the financial statements. The amount of the gain contingency is only included when it can be done without being misleading.<sup>35</sup>

### Loss Contingencies

Loss contingencies require much greater consideration. A loss contingency occurs when a liability or the impairment of an asset may transpire. The first consideration in the treatment of a loss contingency is the likelihood of its confirmation which is defined as follows:

1. Probable - The future event(s) are likely to occur.
2. Reasonably possible - The chances of the future event(s) occurring are between remote and less than likely.
3. Remote - There is slight chance of the future event(s) occurring.<sup>36</sup>

A loss contingency is recognized as a charge to income only when it meets two criteria. First, it must be known to be probable prior to the financial statements being issued and second, the amount of the loss must be estimable in a reasonable manner. A range of estimates is permissible if necessary.<sup>37</sup> Even if a loss contingency

is accrued in the financial statements the nature of the loss and the estimate are disclosed in the notes to the financial statements. If no accrual is made, the nature of the loss is still disclosed in the notes with either the amount of the estimate or a statement that it cannot be reasonably estimated.<sup>38</sup> A rule of thumb for accruing loss contingencies, if there is a range of estimates, is to select the amount within the range which is most probable. If no one amount is more likely than another then the lowest amount in the range is used. This is because the actual amount can reasonably be expected to be no lower than that amount.<sup>39</sup> In a case such as this, the notes to the financial statements will contain a disclosure of the highest estimated loss that is reasonably possible. This is to fully disclose any possibility of a loss beyond that accrued in the financial statements and to avoid misrepresentation.

In the case of a loss or possible loss contingency arising after the date of the financial statements but before they are issued, disclosure in the notes to the financial statements is required. Again, the nature, estimate, or range of estimates, or a statement that an estimate cannot be reasonably made must be included. If an estimate can be made, pro forma data on the contingency can be added to the historical financial statements.<sup>40</sup>

An exception to the probability criteria is a guarantee that generally falls under the remote

classification. Disclosure includes the nature and the amount of the guarantee as well as the amount of any recovery if it can be estimated.<sup>41</sup> Regulated enterprises such as public utilities, common carriers, and insurance companies can accrue loss contingencies without considering the two qualifications discussed earlier. They must disclose the accounting policy, nature of the accrual, and the basis for the estimate, as well as the amount of any related balance sheet accounts.<sup>42</sup>

It is permissible for an enterprise to appropriate a portion of retained earnings for loss contingencies. If an enterprise does this, the appropriation must be appropriately labeled and included in the stockholder's equity section of the balance sheet.<sup>43</sup>

As discussed in the section on prior period adjustments, if an estimate proves to be incorrect, including the accrual of a loss contingency, no adjustment of prior period financial statements is necessary. All that is required in this case is that the possible contingency was adequately disclosed at the time. If an acquired firm had any type of contingency prior to the business combination, the amount of the contingency is included in the purchase allocation. The acquisition must have been accounted for by the purchase method and the contingency must have existed prior to the completion of the acquisition. The contingency is either carried at fair value or an amount determined in

accordance with the two rules stated earlier from FASB Statement No. 5, par. 8. Subsequent adjustments are included in net income at the time of the adjustment.<sup>44</sup> Exhibit 2-8 shows the footnote disclosure for a contingency that was not accrued. If it had been accrued it would be a charge to income on the income statement. Its exact position on the income statement depends on whether it was considered to be extraordinary, unusual, etc., in nature.

#### Discontinued Operations

The presentation and disclosure requirements for discontinued operations are promulgated in APB Opinion No. 30 and the AICPA Interpretation of that opinion. The method of handling discontinued operations depends on whether it is a business segment or not. The discontinuation of a product line or a part of a line of business does not constitute a discontinued operation of a business segment and therefore is not included separately in the income statement. If less than a business segment is disposed of, such as a line of business, it is not identified separately on the face of the income statement but is reported in a note. Gain (loss) on disposal and revenue, costs and expenses of the line of business are included in the note. Also earnings per share data should be disclosed.<sup>45</sup>

"Discontinued operations are the operations of a segment of a business that has been sold, abandoned, spun-off, or otherwise disposed of, or if still operating,

Exh. 2-8. Disclosure of a contingency in the notes to the financial statements. (Church's Fried Chicken, Inc., 1984 Annual Report, p. 31.)

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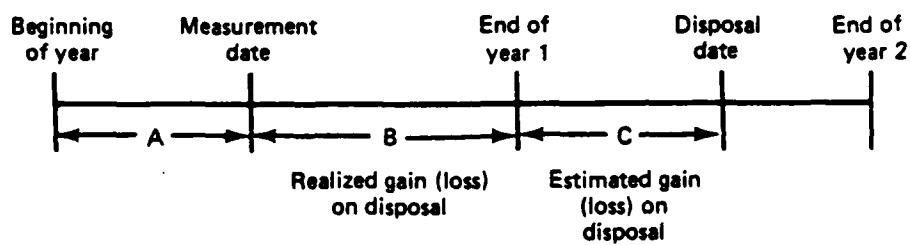
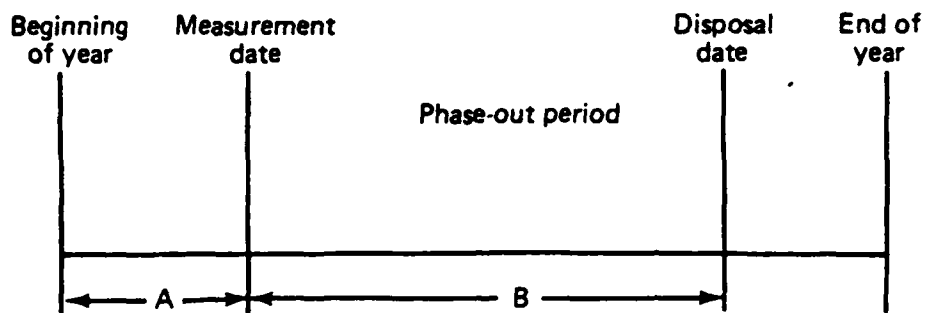
**5. Contingencies**

The company is defending litigation, commenced in 1981-82, in which the former operator of seven franchised stores, and one of its investors, are seeking to recover actual damages in excess of \$38,000,000 and punitive damages in excess of \$16,000,000 for alleged fraudulent misconduct in connection with the franchising of stores in Utah. In 1985 a former officer of the company filed a lawsuit against the company and one of its officers, seeking to recover actual damages of \$10,000,000 and punitive damages of \$10,000,000 for alleged defamation and breach of contract. The company is defending various other lawsuits and claims generally incidental to its business. Management believes that the ultimate disposition of these matters will have no substantial effect on the company.

is the subject of a formal plan for disposal."<sup>46</sup> For a definition of business segment see Chapter III on Segment of Business Reporting. Two dates are important in reporting the results of discontinued operations. The first is the measurement date--the date that a formal plan for disposal or sale of a business segment is approved by management. The second is the disposal date--when the disposal or sale is made final.<sup>47</sup>

Discontinued operations are listed separately from continuing operations on the income statement. They are located after continuing operations and before extraordinary items and/or accounting changes if there are any.<sup>48</sup> The disclosure of discontinued operations in the financial statements consists of two components: income(loss) from operation of a discontinued segment and gain(loss) on disposal of the segment, including a provision for operating loss during the phase-out period. The first component consists of gain(loss) from operation of the discontinued segment from the beginning of the calendar year to the measurement date. The second component includes the gain(loss) on disposal of the segment adjusted by the results of operations during the phase-out period. The phase-out period is the period between the measurement date and disposal date (see exhibit 2-9). In the simplest case, the measurement date and disposal date occur in the same year. However, disposal may not take place until the following

Exh. 2-9. Time line illustration of disposal dates during and after the end of the current year, respectively. (Delaney et al., GAAP Interpretation and Application, pp. 52-53.)



year.<sup>49</sup> This requires that an estimate be made of the gain(loss) on disposal for each year. In either case if the gain(loss) can't be estimated this fact must be disclosed in notes to the financial statements.

In addition to separate disclosure of the results of discontinued operations in the income statement, the related earnings per share amounts should be presented separately from continuing operations either in the notes or on the face of the income statement. Separate amounts are provided for each component that is discontinued operations and gain(loss) on disposal of a business segment.<sup>50</sup>

Other required disclosures in the notes to the financial statements include:

1. Identity of the business segment to be disposed of.
2. Expected date of disposal.
3. Nature of disposal.
4. Description of the remaining assets and liabilities on the balance sheet date.
5. Income(loss) from operations and other proceeds from the disposal of the segment from the measurement date to the balance sheet date.

Disclosure of item 4. can be achieved by listing these items separately on the balance sheet.<sup>51</sup> Prior year figures can be restated to show the discontinued segment's contribution separately from continuing operations for comparative purposes. In the case of a disposal of a business segment in the current year, when the measurement

date was in the prior year, and the estimate made in that prior year requires adjustment, then disclosure of the year of origin, nature, and amount of the adjustment must be made.<sup>52</sup> Exhibit 2-10 shows the typical disclosure in the income statement and statement of changes in financial position. The two components of discontinued operations are located between income from continuing operations and extraordinary items. Note that discontinued operations are listed separately from continuing operations as a source of funds on the statement of changes in financial position. The note disclosure in exhibit 2-11 is more lengthy than the typical note of this type but it serves to illustrate all the required disclosures.

#### Extraordinary Items

The disclosures for extraordinary items are promulgated in APB Opinions 9, 11, 16, and 30; and FASB Statements 4 and 44. An extraordinary item is an event or transaction that is characterized by two requirements. It must be both unusual in nature and infrequent in occurrence. A transaction would be considered unusual if it is unrelated to the enterprise's ordinary activities. If the transaction would not be expected to reasonably occur again in the near future then it is considered to be infrequent in occurrence.<sup>53</sup>

Extraordinary items are presented separately on the income statement from other forms of income. The

Exh. 2-10. Presentation of discontinued operations in the income statement and the statement of changes in financial position. (Adams Resources & Energy, Inc., 1983 Annual Report, pp. 11-13.)

EARNINGS (LOSS) FROM CONTINUING OPERATIONS			
BEFORE INCOME TAXES	5,624	(106)	(1,977)
INCOME TAX BENEFIT (PROVISION)	(1,576)	-	1,018
EARNINGS (LOSS) FROM CONTINUING OPERATIONS	<u>4,048</u>	<u>(106)</u>	<u>(959)</u>
LOSS FROM DISCONTINUED COAL OPERATIONS,			
net of income tax benefits	-	(9,673)	(38,152)
ESTIMATED LOSS ON DISPOSAL OF COAL ASSETS	-	(1,940)	-
EXTRAORDINARY ITEM, utilization of net operating loss			
carryforward	<u>1,576</u>	<u>-</u>	<u>-</u>
EARNINGS (LOSS) FROM DISCONTINUED COAL			
OPERATIONS	<u>1,576</u>	<u>(11,613)</u>	<u>(38,152)</u>
NET EARNINGS (LOSS)	<u>5,624</u>	<u>(11,719)</u>	<u>(39,111)</u>
DIVIDENDS ON REDEEMABLE PREFERRED STOCK	(430)	(430)	(430)
EARNINGS (LOSS) TO COMMON SHAREHOLDERS	<u>\$ 5,194</u>	<u>\$ (12,149)</u>	<u>\$ (39,541)</u>
EARNINGS (LOSS) PER SHARE:			
Earnings (loss) from continuing operations	\$ .59	\$ (.09)	\$ (.24)
Earnings (loss) from discontinued operations	.28	(1.96)	(6.54)
Net earnings (loss)	<u>\$ .85</u>	<u>\$ (2.05)</u>	<u>\$ (6.78)</u>

	Years Ended December 31,		
	1983	1982	1981
FINANCIAL RESOURCES WERE PROVIDED BY:			
Continuing operations -			
Earnings (loss) from continuing operations	\$ 4,048	\$ (106)	\$ (959)
Depreciation, depletion and amortization	2,090	2,165	2,154
Deferred income tax provision	90	-	627
Oil and gas property abandonments	62	1,533	3,555
Other, net	(100)	(335)	(391)
	<u>6,190</u>	<u>3,257</u>	<u>4,986</u>
Discontinued operations -			
Loss from discontinued operations	-	(11,613)	(38,152)
Utilization of net operating loss carryforward	1,576	-	-
Depreciation, depletion and amortization	-	1,562	3,830
Estimated future loss on disposal of assets	-	1,940	-
Deferred income tax benefit	(90)	-	(2,941)
Property and equipment abandonments	-	-	9,016
Provision for loss on coal assets	-	360	22,500
	<u>1,486</u>	<u>(7,751)</u>	<u>(5,747)</u>
Working capital generated by (used in) operations	7,676	(4,494)	(761)
Change in net assets of discontinued operations	(18)	9,257	665
Additions to long-term debt	1,999	3,739	6,700
Property and equipment retirements	2,100	776	322
Issuance of common stock and warrants	2,083	54	4,918
Other	506	141	4
	<u>14,348</u>	<u>9,473</u>	<u>11,848</u>

Exh. 2-11. Disclosure of discontinued operations in the notes to the financial statements. (Adams Resources & Energy, Inc., 1983 Annual Report, p. 16-17.)

(3) Coal Operations

Effective December 31, 1982, the Company's board of directors made a decision to discontinue its coal operations due to the continuing losses and the lack of favorable economic conditions which could improve the Company's possibilities of entering into a joint venture agreement to operate the coal companies. The Company had previously announced its intention to sell or joint venture its entire coal operations. However, to date, the Company has only sold certain of its coal assets.

In the course of its discussions with prospective joint venture partners and purchasers of its coal properties, Company management concluded that the ultimate realizable value of its coal operations was substantially less than its recorded value. Thus, effective December 31, 1981, the Company recorded a \$22,500,000 provision for possible loss on the disposition of its coal assets. The reserve for loss was determined based on management's best estimate of the fair market value of its coal assets at April 23, 1982. Furthermore, effective December 31, 1981, the Company charged against coal operating costs the balance of approximately \$8,900,000 of unamortized capitalized development expenditures incurred on the Company's Illinois coal property and of unrecovered advance royalties recorded on certain Kentucky coal leases. The realizable value of the assets remaining at December 31, 1982, were reevaluated, and an additional \$360,000 provision for possible loss on the disposition of these assets was recorded.

As a result of the currently depressed state of the coal industry, it is difficult to estimate the amount which will be realized from the Company's remaining coal assets. However, there have been no additional provisions for possible loss subsequent to December 31, 1982, and management is of the opinion that the recorded value of the Company's coal assets at December 31, 1983, will be realized. In the event that actual amounts differ from the estimates, adjustments will be made to discontinued operations at that time.

## Exh. 2-11. Continued.

The results of operations of the coal companies for the two years ended December 31, 1982 are reflected in the consolidated statement of operations as loss from discontinued coal operations as follows (in thousands):

	Years Ended December 31,	
	1983	1981
Revenues	\$10,304	\$40,233
Less —		
Costs and expenses	19,893	57,406
Provision for loss on coal assets	360	22,500
Estimated loss on disposal of coal assets	1,940	—
Income tax benefit	(276)	(1,521)
Loss from discontinued coal operations	<u>\$11,613</u>	<u>\$38,152</u>

The estimated loss on disposal of the coal operations includes all anticipated expenses, net of any revenues, subsequent to December 31, 1982, until such time as all assets have been sold or abandoned. This anticipated loss primarily includes future minimum royalty payments, interest expense, costs of reclamation and general and administrative costs.

The Company recognized \$1,576,000 of extraordinary income from discontinued operations during the year ended December 31, 1983. The extraordinary item relates to the utilization of a portion of the coal operations' net operating loss carryforward as an offset to the income tax provided on the earnings from continuing operations.

The assets and liabilities of the discontinued operations have been reclassified on the balance sheet from the historic classifications to separately identify them as net assets of discontinued operations. Condensed balance sheet information for the coal companies as of December 31, 1982 and 1983 is as follows (in thousands):

	December 31,	
	1983	1982
Current assets	\$1,231	\$ 761
Property, plant and equipment, net	5,723	9,068
Notes receivable and other assets	900	1,800
	<u>7,854</u>	<u>11,649</u>
Current liabilities	1,033	3,020
Other liabilities	1,954	3,780
	<u>2,987</u>	<u>6,800</u>
Net assets of discontinued operations	<u>\$4,867</u>	<u>\$ 4,849</u>

The Company has entered into contracts with independent contractors whereby the contractors will mine certain remaining coal reserves of the Company. The contractors will mine these reserves using their own employees and equipment and will pay the Company a royalty with respect to the tonnage of coal produced. The Company made no capital expenditures for this division during 1983.

caption "Income before extraordinary items" is used. Each extraordinary item is listed separately net of tax effects under the general title "Extraordinary Items." If present, discontinued operations are presented before extraordinary items and accounting changes are presented after. The applicable amount of tax is noted parenthetically after each extraordinary item or in the notes to the financial statements. The nature of each extraordinary item must be disclosed. Earnings per share amounts must also be disclosed.<sup>54</sup>

Exhibit 2-12 contains an example of the presentation of extraordinary items on the income statement and the statement of changes in financial position. The required per share amounts are shown at the bottom of the income statement.

#### Unusual or Infrequent Items

APB Opinion 30 and AICPA Accounting Interpretation of Opinion 30 also cover unusual or infrequent items. An item that is either unusual or infrequent but not both must be presented as a separate item of income(loss) from operations in the income statement.<sup>55</sup> It is not displayed net of taxes. The nature and financial effect of each such item is disclosed either on the face of the income statement or in the notes to the financial statements. Items that are of a similar nature and are not material by themselves should be aggregated and listed as one item.

Exh. 2-12. Presentation of extraordinary items in the income statement and the statement of changes in financial position. (The Proctor & Gamble Company, 1983 Annual Report, pp. 21-23.)

EARNINGS FROM OPERATIONS			
BEFORE INCOME TAXES	1,550	1,399	1,186
INCOME TAXES	<u>684</u>	<u>622</u>	<u>518</u>
NET EARNINGS FROM OPERATIONS (before Extraordinary charge)	866	777	668
Extraordinary charge—costs associated with the suspension of sale of Rely tampons (less applicable tax relief of \$58)	<u>—</u>	<u>—</u>	<u>(75)</u>
NET EARNINGS	<u>\$ 866</u>	<u>\$ 777</u>	<u>\$ 593</u>

SOURCE OF FUNDS	<u>1983</u>	<u>1982</u>	<u>1981</u>
Net earnings from operations	\$ 866	\$ 777	\$ 668
Depreciation and depletion	311	267	237
Deferred income taxes	<u>44</u>	<u>83</u>	<u>67</u>
Total from operations	1,221	1,127	972
Extraordinary charge	—	—	(75)
Increase in long-term debt	216	90	80
Decrease in inventories	62	8	41
Increase in debt due within one year	22	26	(134)
Increase in other current liabilities	<u>157</u>	<u>164</u>	<u>88</u>
	1,678	1,415	972

Earnings per share for unusual and infrequent items are not shown on the face of the income statement. An example of a non-recurring (infrequent) item is provided in exhibit 2-13. Exhibits 2-1 and 2-3 show the disclosure of an unusual item in the notes and the income statement.

Exh. 2-13. Presentation of a nonrecurring item in the income statement and disclosure in the notes to the financial statements. (Varian Associates, Inc., 1983 Annual Report, pp. 22-27.)

	Years Ended September 30.		
(Dollars in thousands except per share amounts)	1983	1982	1981
<b>SALES</b>	<b>\$760,250</b>	<b>\$691,199</b>	<b>\$638,357</b>
<b>OPERATING COSTS AND EXPENSES</b>			
Cost of sales	498,904	460,579	438,862
Research and development	50,197	41,315	38,647
Marketing	84,692	85,108	81,683
General and administrative	58,603	51,033	41,655
Total operating costs and expenses	692,396	638,035	600,847
<b>OPERATING EARNINGS</b>	<b>67,854</b>	<b>53,164</b>	<b>37,510</b>
Interest expense	(12,012)	(14,107)	(20,386)
Interest income	12,011	1,783	1,258
<b>EARNINGS FROM CONTINUING OPERATIONS BEFORE NON-RECURRING CREDITS (CHARGES) AND TAXES (BENEFITS)</b>	<b>67,853</b>	<b>40,840</b>	<b>18,382</b>
Non-recurring credits (charges)	4,538	—	(19,452)
<b>EARNINGS (LOSS) FROM CONTINUING OPERATIONS BEFORE TAXES (BENEFITS)</b>	<b>72,391</b>	<b>40,840</b>	<b>(1,070)</b>
Taxes (Benefits) on earnings (loss)	27,510	14,340	(3,240)
<b>EARNINGS FROM CONTINUING OPERATIONS</b>	<b>44,881</b>	<b>26,500</b>	<b>2,170</b>
Loss from discontinued operations, net of taxes	—	—	(5,724)
<b>NET EARNINGS (LOSS)</b>	<b>\$ 44,881</b>	<b>\$ 26,500</b>	<b>\$ (3,554)</b>
<b>EARNINGS (LOSS) PER SHARE—FULLY DILUTED</b>			
Continuing operations	\$ 2.14	\$ 1.47	\$ .14
Discontinued operations	—	—	(.36)
<b>NET EARNINGS (LOSS) PER SHARE—FULLY DILUTED</b>	<b>\$ 2.14</b>	<b>\$ 1.47</b>	<b>\$ (.22)</b>

See accompanying notes to the consolidated financial statements.

#### NON-RECURRING GAIN FOR FISCAL 1983

During the first quarter of fiscal 1983, the Company sold its 18% interest in Benson S.A., a French company, and this resulted in a net gain of \$2.8 million after income taxes of \$1.7 million. This non-recurring net gain increased earnings per share for the year by \$.13.

#### NON-RECURRING CHARGES FOR FISCAL 1981

During the fourth quarter of fiscal 1981, the Company recorded non-recurring charges to continuing operations of \$19.5 million (\$9.9 million after tax). These charges were principally inventory write-downs related to economic conditions in certain markets, employee terminations, and the costs associated with discontinuation or restructuring of several product lines.

### CHAPTER III

#### EXTENDED SCOPE DISCLOSURES

In this chapter disclosures required of enterprises that meet certain criteria such as size or scope of operations are discussed. Reporting the effects of changing prices and segmental reporting are covered here because many large enterprises are required to make these disclosures.

#### Reporting The Effects Of Changing Prices In Financial Reports

GAAP for reporting changing prices in financial reports is promulgated in FASB Statements 33, 39, 40, 41, 46, 54, 69, 70, and 82, as well as FASB Technical Bulletins 79-8 and 81-4. The requirements for reporting the effects of changing prices apply to all publicly held enterprises that pass the specified size test discussed below. Investment companies are excluded from the reporting requirements. Prior to the issuance of Statement of Financial Accounting Standards No. 82, "Financial Reporting and Changing Prices: Elimination of Certain Disclosures" an enterprise that passed the test was required to provide supplemental data on a historical cost/constant dollar and current cost basis. The requirements for historical cost/constant dollar data have been eliminated. Historical cost/constant dollar is historical cost data adjusted for the effects of general inflation.<sup>56</sup> The requirements for

supplemental data on a current cost basis are still in effect. Current cost is a method in which assets and expenses are reported at their current cost or lower recoverable amount as of the balance sheet date or date of expiration or sale.<sup>57</sup>

An enterprise passes the size test if it has at the beginning of the fiscal year for which financial statements are being prepared:

1. Inventories and property, plant, and equipment (before deducting accumulated depreciation, depletion, and amortization) amounting in aggregate to more than \$125 million; or
2. Total assets amounting to more than \$1 billion (after deduction accumulated depreciation).<sup>58</sup>

Non public enterprises and publicly held enterprises, that don't meet the size test, are encouraged to make the disclosures required by FASB Statement 33 as amended by Statement 82. These disclosures are supplemental and do not alter the primary financial statements. Disclosure by business segment is encouraged. The disclosure may be made in the notes to the financial statements or elsewhere in the annual report. The format for the disclosures can take one of two forms, either as a statement similar to the income statement or as a reconciliation. The reconciliation format involves disclosing adjustments to income from continuing operations as it is shown in the primary income statement. Regardless of the format used the amounts of, or adjustments to, cost of goods sold,

depreciation, depletion, and amortization expense must be disclosed.<sup>59</sup>

Disclosure of supplementary information includes the following:

1. Purchasing power gain or loss. (not part of income from operations).
2. Income from continuing operations on a current cost basis.
3. Current cost amounts for inventory and property, plant and equipment at year end.
4. Increases or decreases in current cost amounts for inventory and property, plant and equipment, net of inflation.<sup>60</sup>

If there is no material difference between income from continuing operations determined on a historical cost/constant dollar basis and a current cost basis then historical cost/constant purchasing power information may be substituted in items two and three above. Item four need not be presented. Additionally historical cost/constant dollar information may be substituted in item two of the five year summary information discussed later in this section. Part d) of item two may be eliminated.<sup>61</sup> The notes of the supplementary information must also include:

1. The principal types of information used to calculate the current cost of inventory, property, plant and equipment, cost of goods sold, and depreciation, depletion and amortization expense.
2. The exclusion from the computations of supplementary information of any adjustments to or allocations of the amount of income tax expense in the primary financial statements.<sup>62</sup>

In addition, if depreciation expense has been allocated to several expense accounts in the supplementary computations determining income from continuing operations then the notes must include a disclosure of the total amount of depreciation expense.<sup>63</sup>

There is also a requirement to disclose the following information for each of the last five years:

1. Net sales and other operating revenue.
2. Current cost information
  - a) Income from continuing operations.
  - b) Income per common share from continuing operations.
  - c) Net assets at year end.
  - d) Increases or decreases in current cost amounts of inventory and property, plant and equipment, net of inflation.
3. Other information:
  - a) Purchasing power gain or loss.
  - b) Cash dividends declared per common share.
  - c) Market price per common share at year end.<sup>64</sup>

The notes to the supplemental five year summary must include either the average level or the end of the year level of the consumer price index, which ever was used, for each year included.<sup>65</sup> If the enterprise chooses to include net assets at amounts computed from comprehensive financial statements prepared on a historical cost/constant dollar or current cost/constant dollar basis it must disclose this fact. Explanations of the supplemental information and its significance must be included in the notes to the financial statements.<sup>66</sup> Exhibit 3-1 shows the statement format of

Exh. 3-1. Disclosure of the effects of changing prices. (The May Department Stores Company, Annual Report 1984, p. 27.)

**Supplementary Information on Inflation and Changing Prices (unaudited)**

The following information was prepared in accordance with the Statement of Financial Accounting Standards Nos. 33 and 82 to illustrate the effects of inflation on conventional financial data which is presented in historical cost amounts. The supplementary information is shown under the "current cost" method. The "current cost" method measures the effects of changes in specific prices (current cost) on inventory and property and their related expenses.

**Statement of Earnings Adjusted for Inflation**  
Fiscal Year Ended February 2, 1985

(millions)	As Reported	Current Cost Basis
Net retail sales and rental revenues	\$4,762.4	\$4,762.4
Cost of sales and other related expenses	3,827.1	3,827.1
Depreciation and amortization	108.9	167.9
Other expenses	431.7	431.7
Earnings before income taxes	394.7	335.7
Provision for income taxes	180.6	180.6
Effective income tax rate	45.8%	53.8%
Net earnings	\$ 214.1	\$ 155.1
Gain from decline in purchasing power of net amounts owed		\$ 15.0
Increase in general price level of inventories and property and equipment during the year		\$ 90.3
Increase in current cost of inventories and property and equipment		34.0
Excess of increase in general price level over increase in current cost		\$ 56.3

**Adjustments—Current Cost Basis**

Net retail sales and rental revenues and other operating expenses are considered to approximate average 1984 dollars and, therefore, remain unchanged under the current cost method from the amounts presented in the financial statements.

Depreciation expense was computed under the same methods and estimated useful lives as used in the primary financial statements.

The provision for income taxes is unchanged from the amount in the financial statements since federal and state income tax laws do not allow adjustments to cost of sales or depreciation expense for the effects of inflation. As a result, the company incurs income taxes at a rate of 53.8% in terms of 1984 dollars under the current cost method, significantly in excess of the effective rate of 45.8% shown in the financial statements.

The "Gain From Decline in Purchasing Power of Net Amounts Owed" represents the benefit of having net outstanding liabilities which will be repaid in dollars of less value. This amount is calculated using the company's average net monetary liabilities for 1984, which consist primarily of accounts receivable, current liabilities and long term debt, multiplied by the change in CPI-U in 1984. Monetary assets and liabilities are those which are, or will be, converted into a fixed number of dollars regardless of the effects of inflation. This amount does not represent funds available for distribution to shareholders or income as it is presently defined in the financial statements.

The company uses the LIFO (last-in, first-out) inventory method for substantially all inventories which results in cost of sales that approximates current cost.

Current cost of retail and related support buildings and equipment was calculated using engineering estimates of current cost and the productive capacity of such facilities as determined by analytical techniques. Each facility was analyzed to determine the size necessary to maintain its present sales volume (as if replaced) using current construction techniques and design. All significant facilities and retail operations were included in the determination of current cost values. These estimates have been calculated in accordance with industry guidelines provided by the National Retail Merchants Association.

disclosure presented within the notes to the primary financial statements.

#### Segment of Business Reporting

The requirements for segment of business reporting are promulgated in FASB Statements 14, 18, 21, 24 and 30 and FASB Technical Bulletins 79-4, 79-5 and 79-8. Publicly owned enterprises are required to disclose information about their operations in different industries, foreign operations and exports, and major customers in their annual financial statements.<sup>67</sup> In reporting by business segment the enterprise's first concern is determining the applicable industry segments. This can be achieved by considering three factors.

1. The nature of the product.
2. The nature of the production process.
3. Markets and marketing method.<sup>68</sup>

Once the industry segments are determined it must be established whether each segment must be reported. An industry segment must be reported if it is material. To be considered material it must pass any one of the three 10% tests below.

1. If its revenue is 10% or more of combined revenue of all segments.
2. In absolute amounts, its operating profit is 10% or more of total operating profit of segments that incurred a profit, or its loss is 10% or more of the total operating loss of those segments that incurred a loss.

3. Its identifiable assets are 10% or more of the aggregate identifiable assets of all segments.<sup>69</sup>

The supplementary information required is a disaggregation of that presented in the consolidated financial statements. There is one difference, however. Most of the intercompany transactions are included in segmental reporting whereas they are eliminated in the primary financial statements.<sup>70</sup> If one segment passes all the tests with over 90% no other segment can meet the 10% rule and that segment is considered to be dominant. The segment must be identified but detailed segmental reporting is not necessary.<sup>71</sup>

Prior period segment of business statements are restated for presentation in current year statements when the corresponding financial statements have been restated: a) to reflect a change in accounting principle or entity, or b) the geographic or industry groupings have been changed.<sup>72</sup> This is necessary to facilitate comparison. Disclosure of the restatement includes the nature and effect of the restatement.

#### Different Industries

Separate disclosure of sales to unaffiliated customers and intercompany sales or transfers to other industry segments are required in reporting revenue of a reportable segment. Since intercompany transactions are not eliminated, the basis for accounting for them must be

disclosed and if the basis has changed then the effect on operating profit or loss is included.<sup>73</sup>

Operating profit or loss for each industry segment must be identified and the nature and amount of any unusual or infrequent items must be disclosed. If methods to allocated operating expenses to industry segments change, the effect on the profit or loss of the industry segment and the nature of the change must be disclosed.<sup>74</sup> Other measures of profitability than profit (loss) may be used in the segmental statements but each requires additional disclosures. For example, if contribution to operating profit (loss) is used the disclosures include a description of the difference between the contribution to operating profit and the profit. Other options include net income or a measure of profitability between net income and operating profit (loss).<sup>75</sup>

Regardless of the method employed the aggregate carrying amount of identifiable assets must be presented.<sup>76</sup> Identifiable assets include those used exclusively by the segment or the portion of jointly held assets allocated to the segment. Full disclosure is made of the aggregate amount of depreciation, depletion, and amortization expense for each reportable segment, as well as capital expenditures. Additional disclosure is made of the equity in the net income of and investment in the net assets of vertically integrated unconsolidated subsidiaries. This includes the geographic

area in which they operate. Finally, if there is an accounting change the effect on operating profit of reportable segments is disclosed.<sup>77</sup>

The actual disclosure of the above information can be presented in several ways:

1. Within the body of the financial statements with appropriate explanatory disclosure in the notes to the financial statements.
2. Completely within the notes to the financial statements.
3. A separate schedule included as part of the financial statements.<sup>78</sup>

The amounts reported in the segmental statements, particularly revenue, should reconcile with the corresponding balances in the primary financial statements. If there are any unreported segments they need to be added in order to reconcile the two statements.<sup>79</sup>

#### Foreign Operations and Export Sales

Foreign operations (1) are located outside the enterprise's home country and (2) generate revenue from sales to unaffiliated customers or intraenterprise sales or transfers between geographic areas.<sup>80</sup> They are reported whenever they pass either the first or third 10% test. Foreign operations can be further divided by geographic area. Reportable foreign operations must disclose:

1. Unaffiliated and intraenterprise revenue.
2. Operating profit or loss, or net income, or some similar measure of profitability.
3. Identifiable assets.<sup>81</sup>

Export sales are sales made by the domestic operations of an enterprise to unaffiliated customers in foreign countries. If significant these sales should be reported separately. They can be further subdivided by geographic areas (country, region, etc.) if they are significant at that level.<sup>82</sup>

#### Major Customers

An enterprise's reliance on its major customers must be disclosed if revenue from sales to a single customer exceeds 10% of its total revenue. The amount must be disclosed as well as the industry segment(s) making the sales.<sup>83</sup> Exhibits 3-2 and 3-3 illustrate the disclosures for segmental reporting by industry, geographic area, and export sales as well as by major customer.

Exh. 3-2. Disclosure of reporting by business segment and geographic area. (The Proctor & Gamble Company, 1983 Annual Report, p. 28.)

### 5. Segment Information

Sales between geographic areas and those between business segments, included in net sales below, are made at prices approximating market and are eliminated from total net sales. Corporate earnings include interest income and expense; other general corporate income and expense; and prior to 1982, all exchange gains and losses from translating foreign balance sheets into dollars. Corporate assets include primarily cash and marketable securities.

#### GEOGRAPHIC AREAS

The Company's international operations are conducted in various countries primarily through self-contained subsidiaries. Each country has a distinct social, political, economic and business environment. No individual country accounts for 10% of consolidated sales or assets.

Millions of Dollars	United States	International	Corporate	Total
<u>Net Sales</u>				
1981	\$8,044	\$3,750	\$ (378)	\$11,416
1982	8,610	3,737	(353)	11,994
1983	9,074	3,685	(307)	12,452
<u>Earnings from operations, after tax</u>				
1981	556	130	( 18)	668
1982	685	88	4	777
1983	758	105	3	866
<u>Assets</u>				
1981	4,397	1,769	795	6,961
1982	5,054	1,700	756	7,510
1983	5,344	1,614	1,177	8,135

#### BUSINESS SEGMENTS

The Company's operations are characterized by interrelated raw materials and manufacturing facilities and centralized research and administrative staff functions, making any separate profit determination by product category dependent upon necessarily arbitrary assumptions as to allocations of common costs. Different assumptions or physical or organizational arrangements would produce different results.

Millions of Dollars	Laundry and Cleaning Products	Personal Care Products	Food Products	Other Products	Corporate	Total
<u>Net Sales</u>						
1981	\$4,530	\$4,067	\$2,192	\$ 871	\$ (244)	\$11,416
1982	4,736	4,450	2,192	962	(346)	11,994
1983	4,756	4,780	2,249	1,079	(412)	12,452
<u>Earnings from operations, pretax</u>						
1981	648	460	44	61	( 27)	1,186
1982	660	550	133	53	3	1,399
1983	725	694	117	29	(15)	1,550
<u>Assets</u>						
1981	1,703	2,434	971	1,058	795	6,961
1982	1,710	2,954	1,005	1,085	756	7,510
1983	1,670	2,918	1,219	1,151	1,177	8,135
<u>Capital Expenditures</u>						
1981	156	221	46	129	13	565
1982	155	244	103	112	11	625
1983	199	204	116	81	4	604
<u>Depreciation</u>						
1981	63	93	33	37	11	237
1982	70	109	36	49	3	267
1983	76	133	41	59	2	311

Exh. 3-3. Disclosure of major customer and export sales. (McDonnell Douglas Corporation, 1984 Annual Report, p. 31.)

#### U.S. GOVERNMENT AND EXPORT SALES

Consolidated sales to U.S. Government agencies (including sales to foreign governments through foreign military sales contracts with U.S. Government agencies) amount to \$6,653.7 million in 1984, \$5,506.7 million in 1983, and \$4,857.5 million in 1982. No other single customer accounted for 10% or more of consolidated revenues in 1984, 1983 or 1982.

Foreign sales by geographical area, of which a significant portion were through foreign military sales contracts with the U.S. Government, are shown in the table below:

YEARS ENDED 31 DECEMBER	1984	1983	1982
North America	\$ 539.8	\$ 732.3	\$ 508.7
South America	9.4	18.0	57.0
Europe	651.2	462.2	519.1
Asia/Pacific	466.2	397.3	305.0
Mideast/Africa	467.1	494.9	686.7
	<u>\$2,133.7</u>	<u>\$2,104.7</u>	<u>\$2,076.5</u>

## CHAPTER IV

### SPECIALIZED INDUSTRY DISCLOSURES

There are approximately two dozen industries with specialized disclosure requirements, which are special additions to the general disclosure requirements. They range from the reporting of abnormal costs to write-ups. This chapter will review the specialized disclosures of four such industries, to give the reader a sense of what specialized industry disclosures entail.

#### Banking and Thrift

The required disclosures for banking and thrift institutions are promulgated in APB Opinion 23, FASB Statements 32 and 72, and FASB Interpretation 9. In reporting the acquisition of a bank or thrift institution the general disclosures for business combinations and intangible assets are followed. In addition, if regulatory assistance is granted or recognized in connection with the acquisition a special industry disclosure must be made of the nature and amount of the assistance.<sup>84</sup>

Regulatory authorities require stock and mutual savings and loan associations to appropriate and retain a portion of earnings under general reserves in order to protect depositors. The U.S. Internal Revenue Code allows savings and loan associations to deduct the annual addition

to reserve for bad debts in determining taxable income. The general reserve, as defined by the regulatory authorities, is not directly related to the reserve for bad debts, as defined by the U.S. Internal Revenue Code. However, the purpose and restrictions are similar, so the amount accrued is reported as tax expense of the current year, not as an extraordinary item.<sup>85</sup> The required disclosures are the purpose for which these reserves are provided under applicable rules and regulations. Income taxes may be payable if the reserves are used for something else. This fact and the accumulated amount of reserves for which income taxes have not been accrued must be disclosed.<sup>86</sup>

### Contractor Accounting

#### Construction-type Contracts

Accounting for construction-type contracts is promulgated in Accounting Research Bulletin 45 and FASB Statement 56. Either the percentage of completion or the completed contract method may be used depending on the circumstances. The method used must be disclosed in the financial statements.<sup>87</sup> Commitments to complete contracts in progress are ordinarily considered part of the contractor's business and therefore not disclosed. However in special cases extraordinary commitments may require disclosure.<sup>88</sup>

### Government Contracts

Accounting for government contracts is promulgated in Accounting Research Bulletin 43, chapter 11 and FASB Statement 56. Government contracts are accounted for by the cost-plus-fixed-fee (CPFF) method. There are several unique disclosures and presentations required by this type of contract. If there are any unbilled costs at the balance sheet date then these must be distinguished from the billed amounts on the balance sheet. The amount offset on the balance sheet by advances received on contracts must be disclosed.<sup>89</sup> Termination of a war or defense supply contract involves a set of specialized disclosures which will not be presented here. Exhibits 4-1 and 4-2 show some of the required disclosures for government contracts.

### Development Stage Enterprises

The accounting requirements for development stage enterprises are promulgated in FASB Statement 7 and in the FASB Interpretation of that statement. Kohler defines a development stage enterprise as "an enterprise devoting substantially all of its efforts to establishing a new business without generating significant revenues from the planned principal operations."<sup>90</sup> As such, either the planned principal operations have not commenced, or they have but there has been no significant revenue from them.<sup>91</sup>

A development stage enterprise issues all the financial statements required of an established operating

Exh. 4-1. Presentation of contracts in the balance sheet and the statement of changes in financial position. (McDonnell Douglas, 1984 Annual Report, pp. 22-25.)

<b>Current Assets</b>	Cash and time deposits	\$ 32.2	\$ 26.2
	Short-term investments	2.1	381.0
	Accounts and notes receivable		
	Government	475.3	354.5
	Commercial	470.3	233.5
	Recoverable income taxes		17.1
		<u>945.6</u>	<u>605.1</u>
	Contracts in process and inventories		
	Government contracts in process	5,732.8	3,335.3
	Commercial products in process	1,004.2	791.6
	Materials and spare parts	1,222.2	1,143.1
	Progress payments to subcontractors	1,169.0	949.1
	Less applicable progress payments	<u>(6,544.6)</u>	<u>(4,314.5)</u>
		<u>2,583.6</u>	<u>1,904.6</u>
<b>Current Liabilities</b>	Prepaid expenses	36.0	23.4
	<b>Total Current Assets</b>	<b>3,599.5</b>	<b>2,940.3</b>
	Notes payable to banks	\$ 601.5	\$
	Accounts and drafts payable	633.1	568.5
	Accrued expenses	137.5	122.6
	Employee compensation	228.0	190.3
	Income taxes, principally deferred	856.9	732.4
	Estimated modification, completion, and other contract adjustments	1,088.9	1,032.0
	Current maturities of long-term debt	<u>61.1</u>	<u>18.1</u>
	<b>Total Current Liabilities</b>	<b>3,807.0</b>	<b>2,663.9</b>
<b>Use of Funds</b>	Acquisition cost of acquired companies (excluding cash of \$5.3 and short-term borrowings of \$45.5)	917.3	
	Accounts and notes receivable	178.9	188.5 31.5
	Contracts in process and inventories, net of progress payments	468.4	(531.4) (52.4)
	Other investments	25.1	(4.4)
	Facilities acquired	476.7	351.6 261.9
	Rental equipment and parts	54.4	361.7 57.1
	Cash dividends declared	64.5	55.7 47.6
	Treasury shares purchased	4.1	2.6 12.1
	Miscellaneous	<u>35.0</u>	<u>26.1</u> <u>15.9</u>
		<u>2,224.4</u>	<u>450.4</u> <u>373.7</u>

Exh. 4-2. Disclosure of government contracts in the notes to the financial statements. (McDonnell Douglas, 1984 Annual Report, pp. 26-28.)

**Government Contracts.** Government contracts are primarily accounted for on a percentage-of-completion method wherein sales are recorded at their estimated contract price as the work is performed. Under this method, all costs (including general and administrative expenses) are charged to Costs and Expenses as incurred and the recorded sales values (equal to incurred costs plus estimated earnings) are carried in the account. Government contracts in process. At the time the item is completed and accepted by the customer, the sales value of the item is transferred to accounts receivable.

Certain contracts contain incentive provisions which provide increased or decreased earnings based upon performance in relation to established targets. Incentives based upon cost performance are recorded currently and other incentives are recorded when the amounts can reasonably be determined.

Title to certain items, included in the captions of Materials and Progress payments to subcontractors, is vested in the U.S. Government by reason of progress payment provisions of related contracts.

**Commercial Programs.** Commercial products in process (including military versions of commercial aircraft) are stated on the basis of production and tooling costs incurred less cost allocated to delivered items, reduced (where applicable) to realizable market after giving effect to the estimated costs of completion.

Cost of sales for commercial and military MD-80 aircraft is determined on a specific-unit cost method. Cost of sales of the DC-10 aircraft program, including KC-10 aircraft, is determined on a program-average cost

#### GOVERNMENT CONTRACTS

Contractual authority to supply additional items, or to change the work scope of a contract, prior to reaching final agreement on price is a frequent and normal occurrence in procurements by the U.S. Government, as the contracts contain standard provisions for assuring that the contractor will receive an equitable price in the unusual event a mutually satisfactory price cannot be subsequently negotiated with the Contracting Officer.

Included in Accounts receivable was \$138.1 million at 31 December 1984 and \$69.1 million at 31 December 1983 representing the estimated sales price for items delivered and other work performed, which was not billable because the negotiated price information or documents necessary to invoice under the contract had not been received. Approximately \$8.6 million of the 1984 amount is expected to be collected after one year. In addition, a material portion of the Government contracts in process account similarly represented work performed before the pricing, negotiation and contract documentation cycle had been completed, but the aggregate amount thereof was not identifiable as such in the accounting records.

No material amounts were included in Receivables or Government contracts in process representing retainage for which appropriated funds were not available or the item was otherwise in controversy, other than in respect to normal price negotiations.

enterprise and does so in accordance with GAAP. However, the statements are identified as those of a development stage enterprise and disclosure is made of the nature of the development stage activities.<sup>92</sup> The financial statements also require additional disclosures. The balance sheet will include in the equity section, any cumulative net losses since inception, separately identified with a descriptive caption. The income statement contains current period revenue and expenses, as well as accumulated amounts since inception. The statement of changes in financial position shows sources and uses of funds since inception in addition to those for the current period. Finally the statement of stockholders equity shows from inception the following:

1. For each issuance, the date and number of shares of stocks, warrants, rights or other equity securities issued for cash or other consideration.
2. For each issuance, the dollar amounts assigned to the consideration received for shares of stock, warrants, rights or other equity securities.
3. For each issuance involving noncash consideration, the nature of the consideration and the basis used in assigning the valuation.<sup>93</sup>

The first fiscal year that the business is no longer a development stage enterprise the financial statements must disclose that in prior years it was considered a development stage enterprise. Comparative financial statements, if presented, need not include the additional disclosures discussed above.<sup>94</sup>

Mining Industry

In accordance with FASB Statement 33, "Financial Reporting and Changing Prices," large publicly-held enterprises are required to report the effects of changing prices. (see chapter III) FASB Statement 39 promulgates the reporting of the effect of changing prices on specialized assets including mining assets. An enterprise that owns mineral reserves other than oil and gas must make additional disclosures for the five most recent fiscal years. These include:

1. An estimate of significant quantities proved, or proved and probable, as of the most recent date during the year.
2. The date of the estimate, if not made at the end of the year.
3. Estimated quantity expressed in percentage or physical units, of each mineral product recoverable in significant commercial quantities.
4. Quantities of each significant mineral produced, milled, or processed during the year.
5. Quantities of significant proved, or proved and probable mineral reserves purchased or sold in place during the year.
6. Equivalent market price prior to manufacturing process for mineral products transferred within the enterprise.
7. The average market price of significant mineral products.<sup>95</sup>

Exhibit 4-3 presents the disclosures for a mining enterprise.

Exh. 4-3. Special industry disclosures for a mining enterprise. (National Gypsum Company, 1984 Annual Report, p. 49.)

*Mineral Resources:* The following supplemental information on mineral resources is required by FASB Statement No. 39. The gypsum reserves exclude reserves held by the Company's French gypsum affiliate. Gypsum reserves of the French affiliate are more than adequate to assure its ability to continue its operations and are not otherwise significant to the Company.

**Proven and probable reserves:**

	<i>December 31</i>	
	<i>1984</i>	<i>1983</i>
	<i>(Millions of tons)</i>	
Gypsum	972	977
Limestone	752	790
Cement clay	530	531

**Mined:**

	<i>Year Ended December 31</i>	
	<i>1984</i>	<i>1983</i>
	<i>(Millions of tons)</i>	
Gypsum	6.2	5.5
Limestone	3.4	3.5
Cement clay	0.9	0.7

Mineral resources are mined primarily for use in manufacturing processes. As a minor part of operations, however, the Company sells both gypsum and limestone rock to unrelated third parties at prices determined by market conditions, location and amount of processing prior to sale. In 1984, the Company sold 1.2 million tons of gypsum rock at prices ranging from \$6.00 to \$11.00 per ton. During 1984, slightly more than 100,000 tons of limestone were sold to third parties as crushed limestone at approximately \$25.00 per ton. Because the volume of sales of rock to third parties would not be expected to change appreciably in the event of a significant change in sales prices, any attempt to correlate the market prices to mineral reserves produces information which is probably irrelevant and could be misleading as to the value of these mineral resources.

CHAPTER V  
NOTES TO THE FINANCIAL STATEMENTS

The notes to the financial statements contain a great deal of supplemental and explanatory information. Other than those disclosures required of all enterprises the actual notes to the financial statements are determined by the events or transactions of the particular enterprise. The notes that are discussed below are fairly typical of most enterprises.

Accounting Policies

APB Opinion No. 22, "Disclosure of Accounting Policies," outlines the disclosure and presentation requirements for accounting policies in the notes to the financial statements. The note should identify and describe the accounting principles followed by the enterprise and the methods of applying those principles that materially affect the determination of financial position, changes in financial position, or results of operations. Accounting policies in general include the accounting principles and methods that involve:

1. Selection from existing acceptable alternatives.
2. Principles and methods peculiar to the industry in which the entity operates.
3. Unique applications of GAAP.

This note should either be the first or be in a separate section called "Summary of Significant Accounting Policies."<sup>96</sup> A description of any change in accounting policies is provided with a cross-reference to a separate note disclosing the information required by APB Opinion No. 20, "Accounting Changes."<sup>97</sup> An example of this note is provided in exhibit 5-1.

#### Accounting Changes

In the case of an accounting change the notes should disclose the nature of the change and sound justification for the change which states why the new principle is preferable to the old. Additionally the effect of the change on income before extraordinary items, net income, and the related per share amounts should be provided.<sup>98</sup> If not included in the note on accounting policies then it should be cross referenced to it. Exhibit 5-2 presents the disclosure of an accounting change in the notes.

#### Property, Plant and Equipment

The disclosures required for property, plant, and equipment may be presented in either the financial statements or the notes to the financial statements. One or the other should contain:

1. depreciation expense for the period,

Exh. 5-1. Disclosure of accounting policies in the notes to the financial statements. (Abbot Laboratories, Annual Report 1982, p. 28.)

### Notes to Consolidated Financial Statements

#### Note 1 Summary of Significant Accounting Policies (dollars in thousands)

**Basis of Consolidation** — The consolidated financial statements include the accounts of the parent company and all subsidiaries. All intercompany transactions have been eliminated in the consolidated financial statements. The accounts of foreign subsidiaries are consolidated as of November 30, and translated in accordance with Statement No. 8 of the Financial Accounting Standards Board.

**Inventories** — Inventories are valued at the lower of cost (first-in, first-out basis) or market. Cost includes material and applicable conversion costs.

**Depreciation of Property and Equipment** — Depreciation of physical properties is provided by annual charges to income calculated to amortize the cost of properties over their estimated useful lives. Depreciation has been computed on the straight-line method for financial reporting purposes, and primarily on accelerated methods for income tax purposes, which results in deferred income taxes. Depreciation and amortization in 1982 includes amounts related to certain assets with short lives (\$27,636 book value) reclassified from Other Assets to Property and Equipment. Prior year amounts have not been restated.

**Income Taxes** — Provisions are made for the estimated amount of income taxes on reported earnings which are payable currently and in the future. Investment tax credits are amortized over the lives of the related assets. U.S. income taxes are provided, as applicable, on those earnings of subsidiaries which are intended to be remitted to the parent company. Undistributed earnings reinvested indefinitely in subsidiaries (other than subsidiaries operating in Puerto Rico under tax incentive grants), as working capital and plant and equipment, aggregated \$243,200 at December 31, 1982.

**Start-up Costs** — Expenditures for start-up costs associated with new plants, processes, and production facilities are charged to income as incurred.

**Pension Costs** — Retirement plans cover the majority of employees. Pension costs are provided and funded based on actuarial determinations which include normal costs and amortization of prior service costs over periods not exceeding 40 years.

**Product Liability** — Provisions are made on a current basis for the portions of probable losses which are not covered by product liability insurance.

**Earnings per Common Share** — Earnings per common share are computed by dividing net earnings by the weighted average number of common shares outstanding.

Exh. 5-2. Disclosure of accounting changes in the notes to the financial statements. (Air Products and Chemicals, Inc., 1983 Annual Report, p. 30.)

**Accounting Changes**

In fiscal 1982, the company changed from the deferral method to the predominant U.S. industry practice of accounting for investment tax credits by the flow-through method. At the same time, the company adopted Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation". For more information, see the "Foreign Currency Translation" and "Investment Tax Credits" sections of this footnote.

2. balances of major classes of depreciable assets, by nature or function, at the balance sheet date,
3. accumulated depreciation, either by major class of depreciable assets or in total, at the balance sheet date, and
4. a general description of the method(s) used in computing depreciation with respect to major classes of depreciable assets.<sup>99</sup>

#### Retained Earnings

Restrictions on appropriated and unappropriated accounts may be explained in the footnotes to the financial statements rather than recorded on the balance sheet. Any other conditions affecting retained earnings which cannot adequately be disclosed in the financial statements should be presented in the notes. Information on retained earnings is included in a note on the components of stockholders' equity. An example of this type of disclosure is provided in exhibit 5-3.

#### Subsequent Events

Subsequent events occur between the balance sheet date and the date that the financial statements are issued. As per Statement of Auditing Standards No. 1, "Subsequent Events," there are two types of subsequent events. The first is when additional information is available about an event that existed on or before the balance sheet date and that information affects estimates made in preparing the balance sheet. This type of subsequent

Exh. 5-3. Disclosure of stockholder's equity and retained earnings in the notes to the financial statements. (Mattel, Inc., Annual Report to Shareholders for the year ended January 28, 1984, pp. 49-50.)

#### Note 5

#### Shareholders' Equity

**Outstanding Shares**—Total number of shares outstanding at the end of each fiscal year is as follows:

	1984	1983
825 Series A Convertible Preferred Stock	2,371,948	2,371,998
Common Stock	18,340,144	18,322,366

**Series A Convertible Preferred Stock**—Each preferred share is convertible into 2.12 shares of the Company's common stock. Beginning June 1982, the preferred stock became redeemable at the Company's option in cumulative annual increments of 605,000 shares at an initial price of \$27.50 per share decreasing to \$25.00 per share in June 1986. Outstanding preferred shares have a preference on voluntary liquidation of the Company of \$26.875 per share (\$64 million in aggregate).

**Common Stock Warrants**—At January 28, 1984 warrants to purchase 2,904,000 shares of the Company's common stock at \$4.00 per share are exercisable and expire on April 5, 1986.

**Stock Options**—A total of 503,850 shares were reserved as of January 28, 1984 for issuance to officers and other key employees under a non-qualified stock option plan adopted in fiscal 1979. Of the shares reserved for issuance under the 1979 non-qualified plan, 98,050 shares were available for future grant at January 28, 1984. Future options under this plan shall be granted at not less than the fair market value of the stock on the date of grant. The options granted under the non-qualified stock option plans expire ten years from date of grant. All options are contingent upon continued employment and are exercisable in installments as determined by the Board of Directors or its Stock Option Committee. The following is a summary of the stock option information for the 1979 non-qualified plan for fiscal 1984:

1979 Non-qualified plan	Options Outstanding	
	Shares	Price
Outstanding at January 29, 1983	455,300	\$7.00 to \$20.75
Granted	47,500	\$5.50
Exercised	(12,500)	\$7.61 to \$10.50
Cancelled	(84,500)	\$7.38 to \$17.00
Outstanding at January 28, 1984	605,800 <sup>(1)</sup>	\$5.50 to \$20.75

<sup>(1)</sup>Average purchase price — \$9.64 per share. Expiration dates vary from November 1988 to December 1993. Includes options for 270,800 shares exercisable as of January 28, 1984.

One million shares of common stock were reserved for issuance to officers and other key employees under a non-qualified incentive stock option and restricted stock award plan adopted by the shareholders in June 1982. As of January 28, 1984, no stock options or awards were granted under this plan. This plan also provides that options will be granted at not less than the fair market value of the stock on the date of issue, while awards may be granted at a price not less than the common stock par value. Up to 200,000 shares in the aggregate of the total one million shares provided under this plan are available for grant as stock awards.

**Retained Earnings (Deficit)**—The Company omitted payment of the fiscal 1985 first quarter dividend of approximately \$1,500,000 (\$0.625 per share) on its cumulative Convertible Preferred Stock which would have been payable March 1, 1984. Delaware law (the Company's state of incorporation) prohibits payment of dividends by a corporation which has negative net worth and no current earnings. If the Company were to become delinquent in the payment of six quarterly preferred dividends, the preferred stockholders would be entitled to elect two directors to the Company's board of directors until payment of all unpaid cumulative dividends had been made.

event requires an adjustment to the financial statements. The second type occurs due to a transaction arising after the date of the balance sheet. This type may require disclosure if the financial statements are not to be misleading. For an example of this type of subsequent event see item 9 under Long-term Debt below. If disclosure is required it may be accomplished in the notes or via a supporting schedule or through the use of pro forma statements.<sup>100</sup> The disclosure in the notes is illustrated in exhibit 5-4.

#### Receivables

The notes to the financial statements may include a supporting schedule or other format for providing further information on notes and accounts receivable. Additional information provided in the notes includes the method for determining receivables such as billing and allowances. Additionally, amounts due from related parties must be separately identified in the balance sheet or in the notes.<sup>101</sup>

#### Long-Term Debt

##### Notes and Bonds Payable

The required disclosures for long-term debt are numerous and depend on the type of debt and transactions in which they are involved. The following disclosures are required in the notes to the financial statements for each issue of bonds or notes payable:

Exh. 5-4. Disclosure of subsequent events in the notes to the financial statements. (The May Department Stores, 1984 Annual Report, p. 27.)

**Event Subsequent To Year End**

In March 1985, the company purchased Metropolitan Life Insurance Company's 50% interest in its Parklabrea real estate partnership for \$10 million in cash and \$100 million by issuing five million shares of Series X voting preference stock, stated value \$20 per share, redeemable from 1988 through 1992 in five \$20 million annual payments. The annual dividend rate ranges between \$3.5-\$5.0 million through October 1, 1987, and is negotiable thereafter. Under certain specified conditions relating to future operations, payment of additional dividends may be required as well as additional purchase price amounts of up to \$30 million. Additionally, the holder of the preferred shares may, at its option, call for redemption of the shares after 30 months. Additional purchase price amounts, if and when paid, will be considered a cost of the properties to which they relate. The direct impact of this transaction is not significant to the results of operations or financial position of the company.

1. The nature of the liabilities.
2. Their maturity dates.
3. Interest rates, both the effective and stated.
4. Call provisions.
5. Conversion privileges.
6. Restrictive covenants (i.e., sinking fund requirement, restrictions on retained earnings, etc.).
7. Assets pledged as collateral. The assets are shown in the asset section of the balance sheet.
8. Amounts due to related parties including officers, directors, and employees and the terms of the settlement.
9. Disclosure of notes or bonds issued subsequent to the balance sheet date.
10. Amounts of unused letters of credit.<sup>102</sup>

The required disclosures in the notes are illustrated in exhibit 5-5.

#### Extinguishment of Debt

Additional disclosures are required whenever debt is extinguished and presented on the income statement as an extraordinary item. Not all extinguishment of debt is classified as an extraordinary item. APB Opinion 30, par. 24 provides the criteria for determining if an extinguishment of debt is material as to be considered an extraordinary item. In the event that an extinguishment of debt is classified as an extraordinary item, the disclosures listed below would apply. These disclosures may be presented on the face of the

Exh. 5-5. Disclosure of long-term debt in the notes to the financial statements. (Abbot Laboratories, Annual Report 1982, p. 29.)

**Note 5 Long-Term Debt** (dollars in thousands)

Following is a summary of Long-Term Debt, net of current maturities, at December 31:

	1982	1981	1980
9.20% sinking fund debentures (a)	\$ 89,539	\$ 89,539	\$ 89,539
7% sinking fund debentures (b)	25,644	41,605	42,392
6% sinking fund debentures (c)	10,186	10,204	10,293
Industrial revenue bonds, at various rates of interest, averaging 8.2%, and due at various dates through 2012	45,800	41,800	26,800
Other, principally term borrowings by foreign subsidiaries guaranteed by the parent company, at various rates of interest, averaging 10.5%, and due at various dates through 2006	19,768	25,647	22,256
<b>Total</b>	<b>\$190,937</b>	<b>\$208,795</b>	<b>\$191,280</b>

(a) Due 1999, subject to annual sinking fund payments beginning in 1984 of not less than \$6,250 nor more than \$12,500 principal amount of debentures.

(b) Due 1996, subject to annual sinking fund payments of not less than \$3,000 nor more than \$6,000 principal amount of debentures.

(c) Due 1993, subject to annual sinking fund payments of not less than \$1,250 nor more than \$2,500 principal amount of debentures.

Payments required on long-term debt outstanding at December 31, 1982 are \$18,697 in 1984, \$7,753 in 1985, \$10,174 in 1986, and \$8,685 in 1987.

income statement or provided in the notes to the financial statements. If disclosed in a note then they should be contained within one note; otherwise, sufficient cross-referencing between notes must be provided.

1. A description of the extinguishment transaction, including the sources of the funds used, if practicable.
2. Income tax effects of the transaction during the period.
3. Per share amounts of the aggregate gain or loss, net of tax.<sup>103</sup>

#### Earnings Per Share

Disclosure of the related earnings per share amounts of income from continuing operations, income before extraordinary items, cumulative effect of accounting change, and net income must be presented on the face of the financial statement. Any other per share amounts may be disclosed in the notes. These include operating results of discontinued operations and gain or loss on disposal of a business segment. A schedule or the note to the financial statements concerning earnings per share amounts must contain information to explain certain aspects of those amounts.

These include:

1. An identification of any common stock equivalents and of securities used in computing earnings per common share under the assumption of full dilution.
2. The basis for computing earnings per share amounts including a description of the assumptions and any resulting adjustments made.

3. The number of shares issued or assumed on conversion for the most recent year as well as during a subsequent interim period if presented.<sup>104</sup>

All computation and reconciliations necessary to achieve full disclosure must also be disclosed. In addition, supplementary data is required in the event of certain transactions. An example is a conversion after the end of the year but before completion of the financial statements that would have affected primary earnings per share if it had occurred at the beginning of the year. Supplemental disclosure must be made of what primary earnings per share would have been if the conversion had taken place at the beginning of the year.<sup>105</sup>

#### Acquisitions

The disclosures for consolidated financial statements were provided in the chapter on general disclosures. However in the first year that a business combination occurs, when one enterprise acquires another, specific disclosures are required in the notes to the financial statements of the acquiring enterprise if the acquisition is accomplished by the purchase method. The notes must contain the name plus a brief description of the acquired enterprise. The fact that the enterprise was acquired by the purchase method must be stated as well as the following items:

1. The period for which the results of operations of the acquired enterprise are included in the income statement of the acquiring enterprise.
2. The cost of the acquired enterprise and, if applicable, the number of shares of stock issued or issuable and the amount assigned to the issued and issuable shares.
3. A description of the plan for amortization of acquired goodwill and the amortization method, and period.
4. Contingent payments, options or commitments specified in the acquisition agreement and their proposed accounting treatment.<sup>106</sup>

Supplemental information is also presented on a pro forma basis in the notes including the results of operations as if the acquisition had occurred at the beginning of the current year. If comparative financial statements are used then the results of operations for the prior year are disclosed as if the acquisition had occurred at the beginning of that year. At a minimum the pro forma information will include revenue, income before extraordinary items, net income, and earnings per share.<sup>107</sup> Exhibit 5-6 presents an example of this type of note to the financial statements.

Exh. 5-6. Disclosure of an acquisition in the notes to the financial statements. (The Coca-Cola Company, Annual Report 1983, p. 43.)

11. **Acquisitions.** In 1983, the Company purchased various bottling operations. The operating results for these companies have been included in the consolidated statement of income from the dates of acquisition and did not have a significant effect on operating results for 1983.

In June 1982, the Company acquired all of the outstanding capital stock of Columbia Pictures Industries, Inc. ("Columbia") in a purchase transaction. The purchase price, consisting of cash and common stock of the Company, was valued at approximately \$692 million. The values assigned to assets acquired and liabilities assumed are based on studies conducted to determine their fair values. The excess cost over net fair value is being amortized over forty years using the straight-line method.

The pro forma consolidated results of continuing operations of the Company, as if Columbia had been acquired as of January 1, 1981, are as follows (in millions, except per share data):

	Year Ended December 31,	
	1982	1981
Net operating revenues	\$6,374	\$6,434
Income from continuing operations	489	449
Income from continuing operations per share	3.60	3.31

The pro forma results include adjustments to reflect interest expense on \$333 million of the purchase price assumed to be financed with debt bearing interest at an annual rate of 11%, the amortization of the unallocated excess cost over net assets of Columbia, the income tax effects of pro forma adjustments and the issuance of 12.2 million shares of the Company's common stock.

The pro forma results for the twelve months ended December 31, 1981, have been further adjusted to reflect Columbia's repurchase in February 1981 of 2.4 million shares of Columbia common stock from certain shareholders as if such repurchase had been consummated as of January 1, 1981. Accordingly, interest expense has been increased for amounts necessary to fund the cash portion of the purchase price, legal expenses incurred in litigation with such shareholders have been eliminated and income taxes have been adjusted.

In June 1982, the Company purchased Associated Coca-Cola Bottling Co., Inc. ("Associated") at a cost of approximately \$419 million. Associated was acquired with the intent of selling all properties to other purchasers as part of the Company's strategy to assist in restructuring its bottler system. Accordingly, the acquisition was accounted for as a temporary investment under the cost method of accounting. Approximately 70% of Associated's operating assets were sold in 1982 and the remainder were sold in 1983 for amounts equal to the Company's costs. A substantial portion of such assets were sold for \$245 million to a corporation owned principally by a former director of the Company.

In September 1982, the Company purchased for cash Ronco Foods Company, a manufacturer and distributor of pasta products. This transaction had no significant effect on the Company's operating results.

## CHAPTER VI

### AUDIT REPORTS

Audit reports are not part of the enterprise's financial statements but rather are an opinion expressed regarding the financial statements. The preparer of financial statements follows the pronouncements of GAAP the auditor follows GAAS. Audit reports are included here because the type of opinion that is expressed about an enterprise's financial statements, favorable or otherwise, depends quite heavily on the enterprise's compliance with the presentation and disclosure issues such as those that have been covered in the prior chapters. The APB, FASB, and SEC have over the years established requirements for disclosure and presentation in financial statements in order to ensure that those statements can be understood by the layman as well as the seasoned investor. The audit report gauges how well an individual enterprise's financial statements may have achieved that goal by expressing an opinion as to whether they are misleading or not.

#### Unqualified Opinion

If the financial statements are prepared in full accordance with the requirements of GAAP, consistently applied, and the audit is performed in complete compliance with GAAS then the auditor will render an opinion that the

financial statements present fairly the financial position and the results of operations and the changes in the financial position for each year covered by the statements.<sup>108</sup>

#### Qualified Opinion

A qualified opinion is rendered under several circumstances:

1. Whenever the auditor believes that there is a departure from GAAP that materially affects the financial statements.
2. When fair presentation is not possible due to the lack of disclosure of essential information.
3. When there has been a material change in accounting principle or the method of its application so that GAAP has not been applied consistently.

In addition, if in performing the audit the auditor finds a "lack of sufficient competent evidential matter" or the scope of the audit is restricted the auditor may choose to issue a qualified opinion. The auditor must have determined that an adverse opinion or disclaimer is not appropriate.<sup>109</sup>

#### "Except For"

In the case of an "except for" qualified opinion the audit report will disclose all substantive reasons for this type of opinion being rendered in a separate paragraph. This is called the explanation paragraph and includes the effects of the reason for the qualification on the financial

position, results of operations, and changes in financial position, if they can be determined in a reasonable manner.<sup>110</sup> The opinion paragraph will contain the appropriate qualifying language ("except for") and refer to the explanation paragraph. Exhibit 6-1 contains an example of this type of audit opinion.

#### "Subject To"

A "subject to" qualified opinion is similar in nature to "except for" qualified opinion. It is rendered when an unusual uncertainty exists and another type of opinion would not be appropriate. The explanatory paragraph includes the effects of the uncertainty or statement that they are not reasonably determinable. The opinion paragraph contains the words "subject to" and a description of the uncertainty.<sup>111</sup> An example of a "subject to" opinion is shown in exhibit 6-2.

#### Disclaimer of Opinion

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. This type of audit report is necessary when the auditor is not independent or his audit was not sufficient enough in scope for him to render an opinion. When unusual uncertainties exist and a "subject to" qualified opinion is not appropriate then a disclaimer of opinion will be given. Except in cases of lack of independence the opinion

Exh. 6-1. "Except for" qualified opinion with referenced notes from the notes to the financial statements. (The Coca-Cola Company, Annual Report 1983, pp. 43-46.)

**Report of Independent Accountants**

*The Coca-Cola Company and Subsidiaries*

Board of Directors and Shareholders  
The Coca-Cola Company  
Atlanta, Georgia

We have examined the consolidated balance sheets of The Coca-Cola Company and subsidiaries as of December 31, 1983 and 1982, and the related consolidated statements of income, shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 1983. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of The Coca-Cola Company and subsidiaries at December 31, 1983 and 1982, and the consolidated results of their operations and changes in their financial position for each of the three years in the period ended December 31, 1983, in conformity with generally accepted accounting principles consistently applied during the period except for the change in 1982, with which we concur, in the method of accounting for foreign currency translation as described in Note 10 to the consolidated financial statements.

*Ernst & Whinney*

Atlanta, Georgia  
February 7, 1984

10. Foreign Operations Currency Translation. In 1982, the Company adopted Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation" (SFAS 52) for translating the financial statements of its foreign operations. An equity adjustment (\$11.7 million) was recorded as of January 1, 1982, for the cumulative effect of SFAS 52 on prior years. Net exchange gains (gains and losses on foreign currency transactions and translation of balance sheet accounts of operations in hyperinflationary economies) included in income were \$9 million for 1983 and \$27 million for 1982. The impact of SFAS 52 on 1981 operating results was not material and such financial statements have not been restated.

Appropriate United States and foreign income taxes have been provided for on earnings of subsidiary companies which are expected to be remitted to the parent company in the near future. Accumulated unremitted earnings of foreign subsidiaries which are expected to be required for use in the foreign operations were approximately \$56 million at December 31, 1983, exclusive of amounts which if remitted would result in little or no tax.

Exh. 6-2. "Subject to" qualified opinion with referenced note from the notes to the financial statements. (Mattel, Inc., Annual Report to Shareholders for the year ended January 28, 1984, pp. 47-56.)

.....  
Report of Independent Accountants

To the Board of Directors and  
Shareholders of Mattel, Inc.

We have examined the consolidated balance sheets of Mattel, Inc. and its subsidiaries as of January 28, 1984 and January 29, 1983, and the related consolidated statements of operations, shareholders' equity (deficit) and of changes in financial position for each of the three years in the period ended January 28, 1984. Our examinations were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying consolidated financial statements show that during the year ended January 28, 1984 the Company incurred a net loss of \$394,065,000 and, at January 28, 1984, had a shareholders' deficit of \$136,148,000. At January 28, 1984 the Company had notes payable to its domestic banks of \$349,000,000 that were converted to a term loan in March 1984 which is due February 2, 1985. As described in Note 3, the Company believes its existing financial resources are adequate to finance its continuing operations during Fiscal 1985. It is not presently determinable, however, as to whether the Company will be able to effect a refinancing plan prior to February 2, 1985 that will enable it to repay the balance of the term loan and provide the seasonal financing that is required for the future continuing operations of the Company thereafter. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to secure sufficient financing for the continuing operations.

In our opinion, subject to the effects on the Fiscal 1984 financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements examined by us present fairly the financial position of Mattel, Inc. and its subsidiaries at January 28, 1984 and January 29, 1983, and the results of their operations and the changes in their financial position for each of the three years in the period ended January 28, 1984, in conformity with generally accepted accounting principles consistently applied, except for the change, with which we concur, in the method of accounting for foreign currency translation as described in Note 1.

*Price Waterhouse*

Los Angeles, California  
March 14, 1984

*Term Loan*—Domestic seasonal borrowings have historically been repaid by the end of the fiscal year. Full repayment was not, however, possible at the end of fiscal 1984 due to the significant losses incurred by discontinued operations. At year-end, the Company and its domestic banks were negotiating terms for an acceptable loan agreement. In March, 1984, the Company entered into an agreement with its domestic banks which converted \$349.0 million of outstanding notes payable to a term loan due February 2, 1985. The term loan is collateralized by a pledge of the Company's primary assets, including accounts receivable, inventory, equipment and tangible and intangible properties. The term loan agreement also prohibits the Company from paying preferred and common dividends. The agreement does not provide for any additional domestic borrowings. The agreement requires weekly repayment beginning November 15, 1984 from available domestic cash in excess of \$20.0 million, which will not repay the entire amount of the term loan prior to its due date. A significant balance of the term loan will remain unpaid at February 2, 1985. The loan requires payment of interest at the prime rate plus 1% and requires that the Company meet certain financial covenant tests with respect to liquid asset balances, bookings and cash disbursements.

Under the terms of the loan agreement, the Company will retain all existing cash plus the proceeds from the sale of discontinued operations (see Note 2), the amounts expected to be collected from refundable income taxes and the termination of the pension plan, and the amounts expected from the sales of certain other assets for use in its operations. The agreement prohibits any additional domestic borrowings.

The Company has historically required substantial seasonal financing, due to the seasonal characteristics of its business. The Company's current operating strategies in combination with the cash currently available and to become available are expected to provide sufficient financial resources for the Company's operations through the fiscal year ending February 2, 1985.

The term loan agreement also commits the Company to diligently pursue a plan to restructure the Company's capitalization prior to February 2, 1985, which is essential to enable the Company to repay the balance of the term loan which will be unpaid at February 2, 1985 and to arrange subsequent seasonal financing required for the continuing operations.

will include a separate paragraph providing all the substantive reasons for the opinion and any reservations that the auditor had regarding fair presentation in conformity with GAAP applied on a consistent basis.<sup>112</sup> The disclaimer of opinion is illustrated in exhibit 6-3.

#### Adverse Opinion

An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or changes in financial position in conformity with GAAP consistently applied.<sup>113</sup> The reasons for an adverse opinion are the same as those for an "except for" qualified opinion but by their nature a qualified opinion is not appropriate. An adverse opinion contains a separate paragraph with the reasons why the adverse opinion is being expressed; the effect of the reason(s) on financial position, results of operations, and changes in financial position; and any other reservations about fair presentation of GAAP that the auditor has. The opinion paragraph must refer directly to the explanation paragraph.<sup>114</sup>

Exh. 6-3. Disclaimer of opinion. (Revere Copper & Brass, Inc., Form 10-K for the fiscal year ended December 31, 1983, pp. 28-29.)

Coopers  
& Lybrand

certified public accountants

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Board of Directors of  
Revere Copper and Brass Incorporated:

We have examined the consolidated financial statements and financial statement schedules of Revere Copper and Brass Incorporated and Subsidiaries as listed in the accompanying index. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note A, on October 27, 1982, the Company filed a petition for reorganization under Chapter 11 of the United States Bankruptcy Code. The Company has been authorized under the Bankruptcy Code to operate its businesses and manage its properties as debtors-in-possession until further order of the Court.

The accompanying financial statements have been prepared on a going-concern basis which contemplates the realization of assets and the liquidation of liabilities in the ordinary course of business. The appropriateness of using the going-concern basis is dependent upon, among other things, confirmation of a plan of reorganization, future profitable operations and the ability to generate sufficient cash from operations and financing sources to meet obligations. As a result of the reorganization proceedings, the Company may be required to further curtail operations and/or sell assets or liquidate liabilities for amounts lower than those reflected in the financial statements referred to above. In addition, a substantial number of proofs of claim have been filed with the Bankruptcy Court, including those resulting from the Company's rejection or breach of certain executory contracts, and others may still be filed. The Company has, as yet, not determined the validity of such claims. The ultimate outcome of the foregoing cannot presently be determined.

Also, as discussed in Notes B(1) and B(3), the Company is involved in litigation and contractual negotiations, the ultimate outcome of which cannot presently be determined.

Our report on the 1982 consolidated financial statements made reference to a petition filed by an electric power supplier seeking to prohibit the District Court and the Bankruptcy Court from exercising any jurisdiction in respect of the Company's Chapter 11 case. During 1983, the petition was withdrawn and, accordingly, reference to this matter in our present report on the 1982 consolidated financial statements, as presented herein, has not been made.

Exh. 6-3. Continued.

Board of Directors of  
Revere Copper and Brass Incorporated - 2

Effective January 1, 1983, the Company made a change, with which we concur, in the method of valuing certain inventories as discussed in Note E to the consolidated financial statements.

Because of the materiality of the matters referred to in the third and fourth paragraphs, we are unable to, and do not, express an opinion on the consolidated financial statements and financial statement schedules of Revere Copper and Brass Incorporated and Subsidiaries as of December 31, 1983 and 1982 and for the years then ended.

In our opinion, the financial statements referred to above present fairly the consolidated results of the operations and changes in the financial position of Revere Copper and Brass Incorporated and Subsidiaries for the year ended December 31, 1981, and the 1981 financial statement schedules referred to above, when considered in relation to the basic financial statements taken as a whole, present fairly the information required to be included therein, all in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

For the reasons stated in Note Q, the Company has omitted the changing prices information which the Financial Accounting Standards Board has determined need not be a part of but should supplement the basic financial statements.

*Coopers & Lybrand*

New York, New York  
February 3, 1984.

## CHAPTER VII

### SUMMARY

This professional report has covered some of the disclosure and presentation issues associated with financial statements. Disclosure and presentation issues associated with financial statements are numerous and diverse in nature. A cross section of the many types of disclosures and presentations has been provided in Chapters II through V.

The general disclosures which apply to all publicly held enterprises include some common events such as consolidation. Disclosure of consolidation is made in the headings to the financial statements and in the notes to the financial statements. General disclosures also include some less common events or transactions such as unusual items. The presentation of unusual items is made as a separate line item of income from continuing operations. Disclosure is made in the notes to the financial statements.

The extended scope disclosures apply to publicly held enterprises of specific size or scope of operations. The two extended scope disclosures presented represent very common disclosures among the larger enterprises. The requirements for reporting the effects of changing prices in financial reports apply only to enterprises with at least a certain size of operations. Enterprises

which pass the size test must supply additional information on a current cost basis. In business segment reporting the material segments of the business are determined. Reporting is accomplished by different industries, foreign operations and export sales, and major customer.

The specialized industry disclosures apply to enterprises operating in specific industries. There are many industries that require specialized disclosures. The industries presented in this report are fairly typical of those required to make this type of disclosure. For instance mining industries are required to provide additional information about their mineral reserves other than oil and gas.

The notes to the financial statements are basically the same from enterprise to enterprise. The actual notes presented depend on the events or transactions that occurred for any one enterprise. The notes discussed in Chapter V are fairly typical of all enterprises. All enterprises must disclose their accounting policies. This may be done as the first note within the notes to the financial statements or as a separate note preceding them entitled "Summary of Significant Accounting Policies." Other notes such as accounting changes or subsequent events are not as common. These require disclosure within the notes.

The various audit opinions were presented to illustrate the effect disclosure and presentation have on

the outcome of an audit. If disclosure and presentation is performed properly and completely an unqualified opinion should be rendered. Insufficient or improper disclosure and/or presentation can result in a qualified opinion (either "except for" or "subject to"), a disclaimer of opinion, or an adverse opinion.

The disclosure and presentation issues covered in this professional report were chosen to acquaint the beginning accounting student with the variety of disclosure and presentation requirements. Emphasis was placed on the disclosures and presentations not commonly covered in the typical first year accounting textbook. The exhibits containing excerpts from actual financial statements were provided to present a clearer picture of the proper presentation and disclosure of these transactions or events. As such this professional report should be useful as a supplement to the typical textual materials available for introducing students to financial accounting principles.

# ENDNOTES

1. Eric Louis Kohler, Kohler's Dictionary for Accountants, ed. by W.W. Cooper and Yuji Ijiri, Prentice-Hall Series in Accounting, 6th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), p. 176.
2. FASB, Accounting Standards Current Text as of June 1, 1982 (Stamford, Conn., 1982), p. 49703
3. Ibid.
4. Ibid., p. 49704.
5. Patrick R. Delaney et al., GAAP Interpretation and Application (New York: John Wiley & Sons, 1985), p. 34.
6. TRW Inc., 1984 Annual Report, p. 29
7. American Broadcasting Companies, Inc., 1984 Annual Report, p. 63.
8. Campbell Soup Company, 1982 Annual Report, p. 30.
9. Delaney et al., GAAP Interpretation and Application, p. 35.
10. Ibid.
11. Another adjustment not discussed here results from realization of income tax benefits of preacquisition operating loss carryforwards of purchased subsidiaries. This information can be found in FASB, "Prior Period Adjustments," Statement of Financial Accounting Standards No. 16 (Stamford, Conn., 1979), par. 11.b.
12. APB, "Accounting Changes," APB Opinion No. 20, (New York: AICPA, 1971), par. 13.
13. Ibid.
14. Ibid., par. 37.
15. FASB, "Prior Period Adjustments", par. 16.
16. APB, "Reporting the Results of Operations," APB Opinion No. 9, (New York: AIPCA, 1972), par. 18.

17. Ibid., par. 27.
18. FASB, "Prior Period Adjustments", par. 13.
19. Ibid.
20. Ibid., par. 14.
21. Ibid.
22. Ibid., par. 15.
23. APB, APB Opinion No. 20, par. 35.
24. FASB, "Reporting a Change in Accounting for Railroad Track Structure," Statement of Financial Accounting Standards No. 73, (Stamford, Conn., 1983), par. 3.
25. Ibid., par. 28.
26. Kohler, Ibid., p. 398.
27. "A subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owner. There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two enterprises would be more meaningful and useful." This information can be found in Committee on Accounting Procedure, "Consolidated Financial Statements", Accounting Research Bulletin No. 51, (New York: AICPA, 1959), par. 2.
28. Ibid., par. 1.
29. Ibid., par. 5.
30. Committee on Accounting Procedure, "Consolidated Financial Statements," par. 4.
31. FASB, "Accounting for Leases, " Statement of Financial Accounting Standards No. 13, (Stamford, Conn., 1976), par. 31.
32. FASB, "Accounting for Certain Marketable Securities," Statement of Financial Accounting Standards No. 12, (Stamford, Conn., 1975), par. 20.

33. Committee on Accounting Procedure, "Consolidated Financial Statements", par. 12.
34. FASB, "Accounting for Contingencies," Statement of Financial Accounting Standards No. 5, (Stamford, Conn., 1975), par. 1.
35. Ibid., par. 17.
36. Ibid., par. 3.
37. Ibid., par. 8.
38. Ibid., par. 10.
39. FASB, "Reasonable Estimation of the Amount of a Loss," FASB Interpretation No. 14, (Stamford, Conn., 1976), par. 3.
40. FASB, "Accounting for Contingencies," par. 11.
41. Ibid., par. 12.
42. Ibid., par 13.
43. Ibid., par. 15.
44. FASB, "Accounting for Preacquisition Contingencies of Purchased Enterprises," Statement of Financial Accounting Standards No. 38., (Stamford, Conn., 1980), par. 4-6.
45. Alan B. Afterman, Accounting and Auditing Disclosure Manual, (Boston: Warren, Gorham & Lamont, 1985), p. 155-156.
46. APB, "Reporting the Results of Operations," APB Opinion No. 30, (New York: AICPA, 1973), par. 8.
47. Ibid., par. 14.
48. Ibid., par. 8.
49. When disposal is estimated to be completed within one year and subsequently is revised to a longer period of time any revision of the net realizable value of the segment should be treated as a change in estimate. Ibid., par. 15, fn. 6.

50. Ibid., par. 9.
51. Ibid., par. 18.
52. Ibid., par. 25.
53. Ibid., par. 20.
54. Ibid., par. 11-12.
55. Ibid., par. 26.
56. Delaney et al., GAAP Interpretation and Disclosure, p. 499.
57. FASB, "Financial Reporting and Changing Prices, " Statement of Financial Accounting Standards No. 33, (Stamford, Conn., 1979), par. 22.
58. Ibid., par. 23.
59. Ibid., par. 32.
60. FASB, "Financial Reporting and Changing Prices," par. 29-30.
61. FASB, "Financial Reporting and Changing Prices: Elimination of Certain Disclosures," Statement of Financial Accounting Standards No. 82, (Stamford, Conn., 1984), par. 4.
62. Ibid., par. 34.
63. Ibid., par. 33.
64. Ibid., par. 35.
65. Ibid.
66. Ibid., par. 36-38.
67. FASB, "Financial Reporting for Segments of a Business Enterprise," Statement of Financial Accounting Standards No. 14, (Stamford, Conn., 1976), par. 1.
68. Delaney et al., GAAP Interpretation and Application, p. 467.
69. FASB, "Financial Reporting for Segments of a Business Enterprise," par. 15.

70. Ibid., par. 8.
71. Ibid., par. 20.
72. Ibid., par. 40.
73. Ibid., par. 23.
74. Ibid., par. 24.
75. Ibid., par. 25.
76. Ibid., par. 26.
77. Ibid., par. 27.
78. Ibid., par. 28.
79. Ibid., par. 30.
80. Ibid., par. 31.
81. Delaney et al., GAAP Interpretation and Application, p. 470.
82. Ibid., p. 36.
83. FASB, "Disclosure of Information about Major Customers," Statement of Financial Accounting Standards No. 30, (Stamford, Conn., 1979), par. 6.
84. FASB, "Accounting for Certain Acquisition of Banking or Thrift Institutions," Statement of Financial Accounting Standards No. 72, (Stamford, Conn., 1983), par. 11.
85. APB, "Accounting for Income Taxes - Special Areas," APB Opinion No. 23, (New York, N.Y.: AICPA, 1972), pars. 19-20.
86. Ibid., par. 24.
87. Committee on Accounting Procedure, "Long-term Construction-Type Contracts," Accounting Research Bulletin No. 45, (New York: AICPA, 1955), par. 15.
88. Ibid., par. 16.

89. Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," Accounting Research Bulletin No. 43, (New York: AICPA, 1953), chap. 11, sec. A, pars. 21-22.
90. Kohler, Kohler's Dictionary for Accountants, p. 172.
91. FASB, "Accounting and Reporting by Development Stage Enterprises," Statement of Financial Accounting Standards No. 7, (Stamford, Conn., 1975), par. 8.
92. Ibid., par. 12.
93. Ibid., par. 11.
94. Ibid., par. 13.
95. FASB, "Financial Reporting and Changing Prices: Specialized Assets - Mining and Oil and Gas," Statement of Financial Accounting Standards No. 39, (Stamford, Conn., 1980), par. 13.
96. APB, "Disclosure of Accounting Policies," APB Opinion No. 22, (New York: AICPA, 1972), par. 12.
97. Ibid., par. 14.
98. APB, "Accounting Changes," par. 17.
99. APB, "Ombibus Opinion - 1967," APB Opinion No. 12, (New York: AICPA, 1967), par. 5.
100. Delaney et al., GAAP Interpretation and Application, p. 36.
101. Ibid., p. 90.
102. Ibid., pp. 285-286.
103. FASB, "Reporting Gains and Losses from Extinguishment of Debt," Statement of Financial Accounting Standards No. 4, (Stamford, Conn., 1975), par. 9.
104. APB, "Earnings Per Share," APB Opinion No. 15, (New York: AICPA, 1969), pars. 20-21.
105. Ibid., par. 22.
106. APB, "Business Combinations," APB Opinion No. 16, (New York: AICPA, 1970), par. 95.

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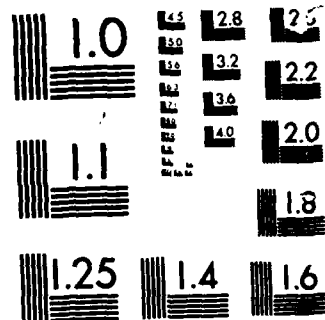
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107. Ibid., par. 96.
108. ASB, Codification of Statements on Auditing Standards, (Chicago, Ill.: Commerce Clearing House, Inc., 1982), par. 509.28.
109. Ibid., par. 509.29.
110. Ibid., par. 509.32-509.35.
111. Ibid.
112. Ibid., par. 509.45-509.47.
113. Ibid., par. 509.41.
114. Ibid., par. 509.42-509.44.

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## VITA

Lori Ann Skipper was born in Victoria, Texas on August 4, 1954, the daughter of Marjory Forester Sheen and Jack Wynne Sheen. After completing her work at Air Academy High School, USAF Academy, Colorado in 1972, she entered Eastern New Mexico University at Portales, New Mexico. She received the degree of Bachelor of Business Administration from Eastern New Mexico University in May 1976. During the following years she served in the United States Air Force as a budget officer, attaining the rank of captain. In August, 1983, she entered the Graduate School of Business at the University of Texas at Austin.

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This report was typed by Georgia Bond and Kristi Brown.

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